FARM CREDIT ADMINISTRATION
UNITED STATES DEPARTMENT OF AGRICULTURE
WASHINGTON, D. C.

APPLICATION OF THE FEDERAL INCOME TAX STATUTES TO FARMERS' COOPERATIVES

By

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ERRATA

1. Page 20, second from last line. The missing page numbers are 155-161.

2. Page 52, paragraph 237, last sentence. Change to read: "(see pp. 89-90)."

3. Page 164, Crop operations, corporations financing, exemption, Change to read: "14(E), Page 161(E)"

4. Page 166, Insurance companies or associations, mutual hail, cyclone, casualty, or fire, exemption. Change to read:
" 14(E)
Page 160(E)"

IMPORTANT NOTICE

This report deals only with Section 101(12) of the Revenue Act of 1941 concerning Federal tax exemption for farmers' cooperative marketing and purchasing associations. For the convenience of readers, however, the appendix contains also the tax exemption sections of that Act relating to other types of farmers' organizations. In the case of farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations, Code Section 101(11) and the applicable regulations are reproduced on page 160. It should be pointed out that this Code Section was amended and considerably amplified in the Revenue Act of 1942. This Act contains no amendments to the other code sections in the appendix. On page 153-155 there is reproduced Regulations Section 19.101-1 on "Proof of Exemption," as amended by T.D. 5125, March 5, 1942. This section was amended subsequently by T.D. 5177, October 29, 1942, and by T.D. 5235, March 1, 1943.

THIS SHEET MAY BE PASTED INSIDE FRONT COVER.

FARM CREDIT ADMINISTRATION
A. G. Black, Governor

COOPERATIVE RESEARCH AND SERVICE DIVISION
T. G. Stitts, Chief
W. W. Fetrow, Associate Chief

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F O R E W O R D

Federal income taxation has been in continuous effect in this country since 1913. At that time there were only about 6,000 farmers' marketing and purchasing cooperatives. Those existing were generally small and the areas of operation mostly local. Practically all of them were confined to more or less simple undertakings.

Today, agricultural producers are served by some 20,000 cooperative organizations. Their wide range of activities includes marketing, processing, purchasing, insuring, and the supplying of irrigation water, electric power, and telephone services. Among these are nearly 11,000 associations occupied primarily in the cooperative marketing of farm products and the purchasing of farm supplies.

Many of the marketing and purchasing associations engage in large-scale operations and have complex organizational structures. The farm products and supplies handled through them during the 1941-42 crop season had a value of almost three billion dollars. It is estimated that more than half the farmers in this country are participants in some phase of cooperative activity.

The enlarged scope and volume of activities have increased the difficulty of applying the Federal income tax statutes, regulations, and decisions to the various organizational, legal, contractual, operating, financial, and accounting procedures of both taxable and nontaxable farmers' cooperatives.

This report analyzes the income tax statutes and their interpretations, from the standpoint of the more common problems encountered by associations of farm producers engaged in cooperative marketing, purchasing, and related service functions. It is intended for reference use by cooperative officers and managers, and by their professional advisers, chiefly attorneys and public accountants.

In addition the report contains much of interest to those who may be seeking general information on some of the operating philosophies and procedures that mark the cooperative way of doing business.

Tom G. Stitts, Chief
Cooperative Research and Service Division

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PART I

GENERAL INFORMATION

Nature of this Report

1. This report 1/ arises from a study concerning the effect on agricultural marketing and purchasing cooperatives of the Federal income tax statutes and their official interpretations. Such interpretations are represented by the income tax regulations and rulings issued by the Treasury Department and its Bureau of Internal Revenue; also by the decisions rendered in cases brought before the Board of Tax Appeals and the Federal courts.

2. The conditions under which the described cooperatives are entitled to exemption from the payment of Federal income and related taxes will be discussed, as well as the extent to which they are liable for income taxation when not exempt. (See par. 689 for an outline of the differences between an exempt and a nonexempt status.)

Statutes and Regulations

3. The Federal statute which governs the tax exemption of such cooperatives is section 101(12) of the Internal Revenue Code, Revenue Act of

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1/ See also Hulbert, L. S., Agricultural Cooperatives and Federal Income Taxes; an address delivered at Chicago, Ill., November 10, 1941. 12 pp. F.C.A. Misc. Rpt. 44. (Mimeographed.)

Note.--The authors acknowledge with keen appreciation the helpful counsel, particularly on legal matters, given by L. S. Hulbert, liaison attorney, Officer of the Solicitor, United States Department of Agriculture, Washington, D. C., and on other matters by Dr. E. A. Stokdyk, president, Berkeley Bank for Cooperatives, Berkeley, Calif. Valuable suggestions and assistance were given also by Charles W. Wilson, counsel, National Cooperative Milk Producers' Federation, Washington, D. C., and by Samuel Wilcox, examiner, Civil Service Commission, Washington, D. C. Florence C. Bell, of the Cooperative Research and Service Division's staff, prepared the index and assisted otherwise with editorial suggestions and criticisms.

1941. That section is quoted in full on pages 135-136 herein, for reference purposes. Corresponding sections of prior revenue acts cover exemption for past years. The terms of the present statute have remained unchanged, however, since 1934.

4. Income Tax Regulations 103 issued by the Bureau of Internal Revenue,2/ partly explain and interpret the income tax and exemption statutes. The portion of such regulations which applies to exemption for farmers' marketing and purchasing cooperatives is reproduced on pages 136-158.

5. Whether or not a farmers' association qualifies as a cooperative under the Capper-Volstead law, the Farm Credit Act, other Federal statutes, or any State law is not of controlling significance concerning its eligibility for Federal income tax exemption. That is determined entirely in accordance with the provisions of the Internal Revenue Code.

6. Nonexempt (that is, taxable) farmers' cooperatives are not affected by section 101(12), but come entirely under the other provisions of the Internal Revenue Code and of the Bureau's Income Tax Regulations in very much the same manner as any taxable business corporation. Emphasis is placed on this distinction since the rules applying to tax-exempt organizations often have been confused by cooperative managers and officers with those governing taxable associations. Part II of this report deals only with tax exemption matters, while Part III covers the factors affecting nonexempt organizations. These parts should be considered by the reader as entirely independent of each other.

Facts and Opinions

7. The effect on income taxation, or on the eligibility for tax exemption, of many operating and legal situations more or less common to farmers' cooperatives today, is not clearly or definitely known because specific rulings have not been made yet by the taxing authorities on those particular situations. Until such rulings or decisions are made by the Commissioner of Internal Revenue, the Board of Tax Appeals, or the Federal Courts, all suggested solutions must be considered as mere opinions of what will be held ultimately.

8. While a good part of this report has a factual basis emanating directly from the provisions of the Internal Revenue Code and its official interpretations, another and quite substantial part represents merely the views of the writers. These views should not be considered as binding in any way upon either the Farm Credit Administration, the Treasury Department, or the Bureau of Internal Revenue. In fact, it is emphasized that in deciding upon the status of any particular association, the Commissioner conceivably might rule at variance with the general theories expressed herein.

2/ United States Treasury Department, Bureau of Internal Revenue. Regulations 103 relating to the Income Tax under the Internal Revenue Code. 862 pp. Washington, U. S. Government Printing Office, 1940. See also Supplements.

9. Thus, this publication may be disappointing, at least in part, to the cooperative manager or adviser who is seeking a yes-or-no answer to his questions or problems. However, when legal or operating changes arise which create a doubt as to an organization's continued eligibility for tax exemption, an official ruling on its position may be secured. This is done by reporting such changes in detail to the Commissioner of Internal Revenue (Taxpayers' Ruling Section) at Washington, D. C., as described in paragraphs 60, 64, 66, and 79-81. Certainly it is desirable, if not necessary, so to report any of the situations which are brought under question herein.

Organizations Covered

10. There are several types of companies or associations whose memberships are composed of agricultural producers. The scope of this report, however, is confined to farmers' cooperative associations which are engaged in the marketing of farm products, the purchasing of farm supplies, and related activities.

11. The effect of the Federal income tax statutes on nonexempt (taxable) cooperatives of that type is discussed in part III, beginning on page . Treated in part II, are the marketing and purchasing cooperatives eligible for tax exemption under section 101(12) of the Internal Revenue Code, which are described in that section as follows:

> "Farmers', fruit growers', or like associations..."

12. This clause is interpreted on pages 237 and 239 of Income Tax Regulations 103 to include organizations serving all types of agricultural producers, as follows:

> "...for farmers, fruit growers, livestock growers, dairymen, etc..."

13. The Commissioner has ruled 3/ that the term "like associations" is intended to refer only to organizations composed of producers engaged in occupations similar to farming and fruit growing. In some of the courts, similar decisions were rendered.4/ Accordingly, the Commissioner of Internal Revenue has refused to consider public consumers' cooperatives eligible for exemption under this section, or under other sections as well, of the exemption law. The Board of Tax Appeals upheld the Commissioner's ruling.5/ (See par. 126 regarding shrubbery and flower marketing. See also pars. 125-130.)

3/ See p. 239 of the reference cited in footnote 2.

4/ Garden Homes Company v. Commissioner, 64 F. 2d 593 (1933). Sunset Scavenger Co., Inc. v. Commissioner, 84 F. 2d 453 (1936). National Outdoor Advertising Bureau, Inc. v. Helvering, 89 F 2d 878 (1937).

5/ Cooperative Central Exchange v. Commissioner, 27 B.T.A. 17 (1932).

Other Exempt Farm Groups

14. Some other types of farmers' organizations or companies are entitled to tax exemption, also, when operated in accordance with the provisions of other sections of the exemption statute. Such organizations include labor, agricultural, and horticultural associations; local benevolent life insurance associations, mutual irrigation and telephone companies, and like associations; farmers' or other mutual hail, cyclone, casualty or fire insurance companies or associations; and corporations organized to finance crop operations. While these groups are not embraced within this report, the sections of the law and of the regulations applying to them are reproduced for reference in the Appendix. (See table of contents.)

Objectives

15. The purpose of this publication is simply to set forth such facts, principles, rulings and other information as may be useful to those who are interested in determining the status of agricultural cooperative associations under the Federal income tax and related laws.

16. In almost every detail the principles governing exemption from taxation harmonize with the views of the Farm Credit Administration as to what constitutes a truly mutual, cooperative type of organization. Since the Administration advocates that ideal form for farmers' cooperatives, it does to that extent encourage a legal and operating structure which coincides with the requirements for exemption.

17. As a part of its authorized functions, the Farm Credit Administration, through its banks for cooperatives and other agencies, makes loans to farmers' cooperative associations. Responsibility for the collection of such loans brings about a very real interest in the tax status of borrowing cooperatives. For example, the safety of a loan might be adversely affected if an indebted association which is thought to be exempt should be found liable for income taxes covering a number of prior years.

Expanding Cooperative Movement

18. This country's agricultural development and its cooperative movement in general have received a great forward impetus through the sound and steady progress of farmers' marketing, purchasing and servicing associations. The war effort is creating an enormous stimulus toward the increased use of such cooperative facilities. The need for greater production of foodstuffs and fibres is accompanied by the necessity for their more efficient processing, handling and distribution. Farmers' cooperative associations are playing a prominent role in the effort to achieve those goals.

19. These organizations now have entered a successful era which many believe will continue for years to come. Their operations are expanding and becoming more diversified each day. From small local beginnings many such groups now operate in several States; others do a national and even an international business. From single associations of producers,

agricultural cooperation has developed into federated groups of associations and into superfederations of federated groups.

20. This progress has produced an increased complexity in the business activities of cooperatives, with many new operating and legal methods whose effect on the tax status of the organizations never has been reviewed officially by the taxing authorities. Perhaps these factors, along with the increased importance of income taxation because of the trend toward higher rates, have caused the unusual interest which is being manifested in this subject by those who are guiding the affairs of such enterprises.

Wartime Urgencies

21. Many farm cooperatives today, under stress of the war emergency, have undertaken abnormal and unusual types of activities. Numbers of them are delivering food and other supplies to the armed services and to other governmental agencies, or are handling and processing food products for shipment abroad under the lend-lease program. The effect of these special activities on the tax exemption eligibility of farm cooperative associations remains to be determined. (For a further discussion of this subject see pars. 224-226A.)

Appeals and Suits

22. The broad principles and conditions governing income taxation and exemption therefrom are set forth by Congress in the Internal Revenue Code. The Secretary of the Treasury and the Commissioner of Internal Revenue, charged with administration of the Code, develop regulations and rulings to express their interpretations and to support their levy of tax deficiency assessments.

23. Upon audit of income tax returns, local revenue agents might determine that an additional tax is due. If the taxpayer disagrees with the agent's findings, hearings may be had before the local internal revenue agent in charge and thence before the Income Tax Unit at Washington, D. C. Should these hearings result negatively, the Commissioner of Internal Revenue then will formally notify the taxpayer, issuing what is known as a tax deficiency assessment.

24. Within 90 days after such notice, and before payment of the claimed tax, an appeal may be made to the Board of Tax Appeals for a redetermination of the assessment. If the Board's decision confirms the deficiency, the taxpayer, if so desired, may petition within 3 months for a review of the decision before a circuit court of appeals, and finally, upon certiorari, before the United States Supreme Court. When cases are appealed to the Board and an adverse decision is rendered, the taxpayer may not bring suit for recovery of the tax where it was paid after the Board's decision. On the other hand, the taxpayer may elect to forego an appeal before the Board and when this is done, the tax deficiency may be paid, a claim for tax refund filed, and a suit then brought for recovery of the tax in the Federal District Court or before the Court of Claims.

25. The preliminary procedures available to a cooperative association whose claim for tax exemption is denied or whose tax-exempt status is revoked, are detailed in paragraphs 82-84. If, after the hearings described in those paragraphs, the Commissioner's adverse ruling still stands, a cooperative then may appeal to the Board, but before so doing, it must file tax returns for the year or years demanded by the Commissioner. In such an instance, the cooperative probably would desire to file the returns in a way that shows no tax liability, in accordance with the belief that it is eligible for tax exemption. The Commissioner then would send a tax deficiency assessment notice to the cooperative based upon what he believes to be the taxable income. Only at that point, and prior to actual payment of the tax, may an appeal for redetermination of the deficiency be made to the Board. A petition for subsequent review in the Federal Courts may follow, as outlined in paragraph 24.

26. The details of procedure before the Board and the Courts constitute a subject of rather involved and voluminous proportions which is not intended to be covered in this report. A number of publications exist on this phase of tax-law practice.

Commissioner's Prerogatives

27. While the decisions of the Board of Tax Appeals supersede the Commissioner's ruling in any particular case, he is not bound to follow those decisions when ruling on other cases of a similar nature. It is, therefore, the Commissioner's practice to publish in the Internal Revenue Bulletin (issued weekly) his acquiescence or nonacquiescence in the Board's decisions, thus indicating his possible future course of action. In like manner, the Commissioner is not bound to follow in similar future cases any decisions handed down by the Federal courts, other than the Supreme Court. Except in rare instances, publication is not made of the Commissioner's intentions regarding his future application of court decisions.

Commissioner's Rulings

28. Moreover, the Commissioner's own rulings may not be relied upon to furnish an absolute and definitive precedent for future rulings in cases that appear similar. This feature is indicated in the following quotation from the standard notation appearing on all Internal Revenue Bulletins:

> "The rulings reported in the Internal Revenue Bulletin are for the information of taxpayers and their counsel as showing the trend of official opinion in the administration of the Bureau of Internal Revenue; the rulings, other than Treasury Decisions, have none of the force and effect of Treasury Decisions and do not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury. Each ruling embodies the administrative application of the law and Treasury decisions to the entire state of facts upon which a particular case rests.

"It is especially to be noted that the same result will not necessarily be reached in another case unless all the material facts are identical with those of the reported case. As it is not always feasible to publish a complete statement of the facts underlying each ruling, there can be no assurance that any new case is identical with the reported case. As bearing out this distinction, it may be observed that the rulings published from time to time may appear to reverse rulings previously published..."

PART II
TAX-EXEMPT FARMERS' COOPERATIVES

Tax Legislation History

Early Income Taxes

29. "The income tax is by no means a new thing. It is as old as the tithes of Biblical times, and appeared later in the Roman estimo, the French dixieme, and the English tenth..." 6/ A levy somewhat similar to the modern idea of income taxation had its inception in England in 1379.7/ That country in 1799 adopted a system of taxation which is generally regarded as the beginning of the modern form of income taxation.

United States Legislation

30. Income taxation was first proposed for the United States in 1812 as a means for financing the war with England, but the proposal was not adopted. Again the exigency of war, this time the Civil War, brought forward another movement to tax incomes. The Direct Property Tax Act of August 5, 1861, imposed a modest tax of 3 percent on the excess of all incomes over $800. This tax, however, never was collected as the law was repealed by the Act of July 1, 1862. The latter act, itself, levied a tax of 3 percent on certain incomes and 5 percent on higher incomes.

31. Income taxation continued in effect until 1871 when the Act of July 14, 1870 expired and was not re-enacted. There then was a lapse of 23 years before another income tax became effective with the Act of August 28, 1894. It went into effect on January 1, 1895, with a tax of 2 percent on corporate profits and on the net income of individuals in excess of a personal exemption of $4,000. The Act was short-lived, however, for it was declared unconstitutional in March, 1895, through a decision of the Supreme Court.8/

32. Fifteen years elapsed before the enactment of a corporation excise tax in 1909. "The corporation excise was a very mild and limited form of special income tax, called an excise to avoid constitutional restrictions," according to one publication.9/ The Constitution's Sixteenth Amendment, which was ratified on February 3, 1913, gave definite validity to the general taxation of income. The Federal Government has used that form of taxation continuously since 1913.

6/ Rosa, Charles D. The Theory and Practical Application of a State Income Tax. Indiana Farm Bureau Federation, 1926. See p. 4 thereof.

7/ Mills, Mark Carter, and Starr, George W. Readings in Public Finance and Taxation. 823 pp. New York, The MacMillan Company, 1932. See p 456 thereof.

8/ Pollock v. Farmers' Loan & Trust Company. 157 U.S. 429; 158 U.S. 601 (1895).

9/ Blakey, Roy G., and Gladys C. Founders and Builders of the Income Tax. 19[illegible] pp. Chicago, Commerce Clearing House, 1940. See p. 9 thereof.

Exemption Provisions

33. The Acts of 1909 and 1913 both exempted certain types of nonprofit concerns from income taxation, including "agricultural organizations." In the succeeding revenue acts, the exemption provisions were gradually augmented and clarified. Each revision broadened the range of exemption eligibility for agricultural organizations. In 1926 Congress practically rewrote the entire section concerning the exemption of farmers' cooperatives. With but one slight addition made in 1934, it so stands today as section 101(12) of the Internal Revenue Code, Revenue Act of 1941.

Revenue Act of 1941

34. The present act has 19 different sections granting exemptions to a variety of nonprofit organizations. In addition to farmers' cooperatives, these include such activities as fraternal beneficiary societies, labor unions, building and loan associations, charitable and religious corporations, educational institutions, hospitals, business leagues, clubs, certain mutual companies, etc. It is estimated that approximately 300,000 such organizations have secured exemption.

35. There are now more than 15,000 agricultural cooperative associations and mutual companies in this country, most of which are believed to have secured letters of exemption. While the exact number of these exemptions is not known, it obviously is very small when compared with the aforementioned total of 300,000.

Why Exemption?

36. Congress, it is assumed, saw fit to grant exemption to the foregoing types of nonprofit organizations, when they operate in a prescribed manner, probably for the reason that their existence is considered beneficial to the general public welfare. Whether the privilege of tax exemption is of any great tangible value or advantage to farmers' cooperatives is next discussed.

How Valuable Is Tax Exemption to Farmers' Cooperatives?

Effect of Present Tax Rates

37. The Government's tremendous expenditures for defense and war purposes have forced the imposition of higher rates for Federal income taxes. Some idea of the effect of the 1941 rates may be gained when it is realized that a taxable corporation which in that year had a statutory net income of $100,000 was subject to Federal income, excess profits, and capital stock taxes which might have amounted to more than $45,000. The Revenue Act of 1942 introduced still higher rates. Under that Act normal, surtax, and excess-profits taxes are imposed up to a maximum in certain cases of 80 percent of the surtax net income, less a post-war credit of 10 percent of the excess-profits tax.

Limited Advantage to Cooperatives

38. In one sense the foregoing tax illustration may be taken to indicate the advantage or value of exemption to a farmers' cooperative association. From another viewpoint, however, that conclusion is quite inaccurate. This is so, because it is entirely possible for those associations to be organized and operated in such a way as to have little, if any, taxable income. (This is further explained in par. 558 and others following.)

39. Stated otherwise, if tax exemption were abolished, many farm cooperatives which legally and operatively followed certain rules and principles would be immune from income taxation through the absence of statutory income. This is particularly true of marketing associations operating on a pooling basis or on other agency plans. Other types of cooperatives could minimize their taxable income considerably by following certain legitimate procedures as detailed in part III of this publication. Those procedures are available not only to farmers' cooperatives, but, as well, to any business concern if it agrees in advance with its patrons to make refunds in proportion to patronage.10/ (See par. 568.)

40. The rules and procedures mentioned are entirely compatible with true cooperative principles. Thus, while tax exemption itself means little to a cooperative association, its adherence to a bona fide mutual plan of organization and operation is of great value. Such a plan results in the absence, or at least the minimization, of income on which an association may be taxed under the Federal statutes.

Some Definite Advantages

41. Whether an organization is tax-exempt or not, its distribution of business proceeds to any concern or person ordinarily increases the latter's taxable income, if the concern or person is subject to taxation. Such distributions include dividends on capital shares, as well as patronage refunds or credits. (See also pars. 306-313.) Exempt associations which pay dividends on capital shares have a definite advantage over nonexempt cooperatives in that the latter are taxed on the income represented in such distributions, which are taxable again in the hands of the recipients.

10/ See Uniform Printing & Supply Co. v. Commissioner, 88 F. 2d 75 (1937).

Another advantage exists in that nonexempt organizations cannot avoid income taxation on extraneous (nonoperating) or capital gains. (See pars. 677-679.)

42. All taxable associations or corporations, of course, are assessed for other types of Federal taxes, principally the capital stock tax. The amount of the latter, however, is usually small. Incidentally, the capital stock tax must be paid by all cooperative associations which are not exempt from Federal income taxation, whether they are organized on a capital stock plan, or on a nonstock plan. That tax is levied initially on a declared valuation of net worth.

43. An exempt cooperative, of course, also has the advantage of not being required to prepare annual income and capital stock tax returns. (For a comparison of all factors, see the diagram on pp. 150-151.)

State Taxes and Exemptions

44. The taxes described in paragraph 37 do not include local income taxes which are assessed by many of the States. A number of the latter have provisions in their statutes which are similar to those contained in the Federal exemption law. Ordinarily this means that if an association is exempt under the Federal law, it is likewise exempt from local income taxation in certain States. Some of the local requirements for exemption are less exacting than the Federal regulations. On the other hand, a number of the States do not grant income tax exemption to farmers' cooperatives.

General Rules for Securing and Maintaining a Tax-Exempt Status

Is Exemption Automatic?

45. It has been stated often that exemption from the filing of Federal income tax returns and from the payment of such tax is not automatic and to be secured must be applied for to the Commissioner of Internal Revenue. Technically, however, exemption is granted only by the statute itself. The Commissioner merely affirms or denies the applicant's eligibility therefor.

Delayed Application

46. Furthermore, an organization's eligibility for exemption, or its right to secure affirmation thereof, is not in any way impaired by delay in making application to the Commissioner, nor is there any apparent penalty for such delay. A farmers' cooperative, therefore, may apply for and receive an authentication of its exempt status effective for any number of past years, provided it can show proper detailed proof of elibibility for each of such years. (But see par. 63.)

47. Nevertheless, cooperatives which desire to have their status affirmed are urged not to rely upon the privilege described; rather, they should make formal application as soon as possible. This is desirable particularly because it is quite impossible in many instances to forecast accurately whether the Commissioner will rule an organization is eligible or ineligible.

Tax Refunds

48. A farmers' cooperative organization, eligible for exemption, which has operated in accordance with the requirements for exemption, may secure a refund of Federal income and related taxes which were paid in the erroneous belief that the concern was taxable. Such refunds may be applied for not later than 3 years from the filing date of the tax return, or within 2 years from the time the tax was paid, according to section 322 of the Internal Revenue Code of 1941.

49. When taxes are paid as the result of a deficiency assessment made by the Commissioner of Internal Revenue, their refund is possible only as the result of successful suit for recovery in the Federal Courts, unless, upon redetermination, the Commissioner decides that such taxes were erroneously or illegally assessed and collected. (See also pars. 22-26 and 82-84.)

Application Details

50. Farm cooperatives wishing to have their eligibility for tax exemption confirmed should secure and fill in the Treasury Department's Form 1028, entitled "Questionnaire," which is designed to indicate whether the organization's legal and operating structure conforms with the statutory requirements for exemption.

51. When completed, the application should be subscribed and sworn to by an officer of the cooperative and then forwarded to the Collector of

Internal Revenue for the district in which the principal place of business or principal office of the organization is located. (Form blanks may be obtained from the Collector's office.) It is desirable that the questionnaire, Form 1028, be accompanied by a letter in which pertinent additional information may be given. A copy of such data and of the letter should be retained by the association and should be carefully preserved for convenient reference throughout the association's entire existence.

Letters of Exemption

52. It is the Collector's duty to forward the completed questionnaire to the Commissioner of Internal Revenue (Taxpayers' Ruling Section) at Washington, D. C. If the application is approved, the Commissioner then communicates this information to the applicant in what is known as a letter of exemption. (A better name would be letter of exemption confirmation.) That letter should be carefully preserved in the same manner as described in paragraph 51. Many cooperative associations have carelessly mislaid these important certificates and by so doing are sometimes embarrassed or hampered in proving their tax-exempt status, when occasion demands.

53. After receipt of such a letter it is not necessary for the association to file income or capital stock tax returns, nor to pay those taxes, so long as the conditions of exemption continue to be fulfilled. Issuance of the Commissioner's letter normally takes from 10 to 60 days. In the instance of a newly formed cooperative, however, the Commissioner usually withholds approval until the applicant's books are closed for the first accounting period. This is to permit an observation of the actual operating procedures and to determine the settled financial structure.

Other Exemptions

54. A farmers' cooperative association which is exempt from Federal income taxation under section 101(12) of the Internal Revenue Code is also, by statutory grace, deemed simultaneously exempt from the payment of certain other Federal taxes, namely, the excess-profits tax, the capital stock tax, the documentary stamp tax, and, to a very limited extent, the social security tax.11/

Extreme Care Essential

55. Careful attention should be given to every question or request on the questionnaire (Form 1028). In particular, associations should not overlook sending in the requested copies of financial statements, charter, bylaws, etc. If exemption is claimed for more than one past year, a separate application (Form 1028) must be submitted, along with the described papers, for each such year.

56. It cannot be emphasized too strongly that the information given on the form should be accurate and complete. Any person who wilfully prepares or assists in the preparation of a false or fraudulent return,

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11/ For details of exemption from social security taxation, see Hulbert, L. S. Summary of Cases Relating to Farmers' Cooperative Associations, F.C.A. Summary No. 10. 23 pp. June 1941. (Mimeographed.)

affidavit, or claim in connection with any matter arising under the internal revenue laws "shall be guilty of a felony, and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than 5 years, or both, together with the costs of prosecution."12/

57. The Commissioner's letter confirms eligibility for exemption entirely on the basis of the applicant's reported information. If such data are inaccurate, incomplete or false so as to conceal factors of ineligibility, the concerned organization is legally taxable even though it has received a letter of exemption.

Continuance of Exemption

58. In like manner, exemption continues only so long as the organization's legal structure and operating methods do not change so as to conflict with the statutory requirements. Many cooperative managers have not realized the restricted significance of the Commissioner's letter of exemption. They simply filed it away and proceeded to forget all about the matter, erroneously considering the letter as a sort of blanket authority. In other cases, new managers and new directors came into office without being informed at all of the requirements, or even of the existence of tax exemption.

59. Such situations make it possible for an association holding a letter of exemption to drift gradually and unintentionally into a non-exempt position in which it might continue for a number of years without discovery of the true status. When the Commissioner finally learns of the facts, he is then obliged to revoke the letter of exemption retroactively and call for the filing of income and capital stock tax returns for each of the back years concerned. There will follow an assessment of taxes for such years, with penalties.

Compliance Determination

60. The letter of exemption specifically charges its holder with the responsibility for reporting to the Commissioner whenever any significant changes are made in the legal or operating procedures. While this somewhat resembles what may be termed the honor system, it should not be overlooked that the Bureau has the right, which incidentally it often exercises, of examining the books and affairs of any organization to determine if its eligibility has been maintained and still is intact. In fact, express provision is made for this action, in the following language taken from Regulations 103, page 230:

> "Collectors will keep a list of all exempt corporations [located in their respective districts] to the end that they may occasionally inquire into their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated."
> [Bracketed wording added.]

12/Quoted from section 3793 (a)(b), Internal Revenue Code. See also p. 724 of Income Tax Regulations 103.

61. Under a Treasury ruling (T.D. 5125) issued March 5, 1942, some classes of exempt concerns, not including farm cooperatives, are thereafter obligated to file an annual information return (Form 990), submitting sworn proof of their continued eligibility for exemption. There is some feeling that this procedure may be extended eventually to embrace agricultural associations exempt under section 101(12) of the Code.

Measured by Fiscal Years

62. Under the Bureau's rules, exemption eligibility is determined only in terms of the association's fiscal years. Thus, it is possible to be exempt in one year, not exempt in the next, and so on. Each time exemption is regained, however, a new application to confirm that status must be made to the Commissioner on the Treasury Department's Form 1028. If eligibility is approved, he will issue a new letter of exemption.

63. Whatever situation actually existed during the whole of each 12-month fiscal period governs whether an organization is or is not entitled to tax emption for each such year. Retroactive adjustments of defects will not be acceptable to the Bureau, as is described in the following quotation:13/

> "An association may not, furthermore, amend its articles of incorporation or bylaws to provide for the payment of patronage dividends to nonmembers on the same basis as members and, after so doing, pay the patrons the amount of patronage dividends due them for earlier years and qualify for exemption during the earlier years. The status of each association for exemption purposes for a given year is determined by its form of organization and its actual operations for that year."

Renewed Affirmations Recommended

64. Cooperatives desiring to maintain and guard their exempt status should be continually vigilant. In addition to the reporting which is required, as described in paragraph 60, it is desirable to refile the application Form 1028 every 3 or 5 years so that the Bureau may comprehensively review an association's status. Even if no particular changes have been made, it is considered a good practice to secure reaffirmation of exemption eligibility in the form of a renewed letter of exemption.

65. It is not recommended that Form 1028 be filed annually as that would place an excessive administrative burden on the Commissioner's office.

No Rulings on Hypothetical Situations

66. As mentioned in paragraph 60, exempt cooperatives are obligated to report any significant operating or legal changes immediately to the Commissioner. It is not possible, however, to secure his official written opinion on any action which is merely contemplated and not yet consummated.

13/ From an unpublished paper entitled "Federal Income Taxation and Cooperatives" prepared by the Bureau of Internal Revenue and read at the 15th annual meeting of the Kansas Cooperative Conference held in Manhattan, Kansas, on November 25, 1941.

The Commissioner thus avoids being placed in the position of assenting to, and thus indirectly encouraging, any course which, if followed, might reduce the Government's tax revenue. In other words, if a cooperative association is uncertain whether an expected change will make the organization ineligible for exemption, there is no obligation on the Commissioner to solve the uncertainty until the proposed action goes into effect.

Should Exempt Cooperatives File Tax Returns?

67. Some attorneys and public accountants have advised certain farm cooperatives, which hold letters of exemption, to file Federal income tax returns each year with all data filled in except the tax calculation. This is to secure the benefit of the limitations statute since its provisions do not apply to a letter of exemption. That statute bars the Government from making an assessment of taxes after expiration of 3 years from the filing date of the return, except where the latter is fraudulently made.

68. In advocating this practice, the advisers had in mind protecting the associations from unintentional or unknown transgressions of the exemption requirements. They feel this is justified particularly where the organization is large and has a complicated operating set-up. It is assumed the management has endeavored to observe the exemption conditions but has found that the changes in the association's legal and operating procedures are too numerous to permit of practical reporting to the Bureau. Thus, facing the risk of possible tax assessment for many prior years, the organization seeks to limit its liability to a period of 3 years by filing a tax return in the manner described.

69. Ethical considerations are here involved, for certainly any entity which becomes taxable should pay its just assessments. Extenuating circumstances probably should be taken into account. Consider, for instance, a cooperative whose management believed it exempt and therefore made no provision for income tax expense. The organization is then suddenly called upon to pay several years' taxes. Conceivably this could damage the association's financial position and impair its relations with patrons and creditors.

Board Apparently Sanctions

70. The filing of income tax returns by exempt organizations seems to have been sanctioned by the Board of Tax Appeals when it promulgated a decision on September 12, 1939, in the case of Southern Maryland Agricultural Fair Association v. Commissioner of Internal Revenue, 40 B.T.A. 548, which reads in part as follows:

> "Although this petitioner was encouraged by the action of the Commissioner [his issuance of a letter of exemption] to believe that it would not have to file returns for 1923 and subsequent years, nevertheless, it was never prevented from filing returns. It could have filed returns, and might thereby have started the period of limitations, though still claiming exemption. Some taxpayers take such precautionary steps. There is no inequity in requiring this petitioner to pay the taxes actually imposed upon it by the revenue acts. It could have

avoided the inequity of the penalties by filing returns in 1937, but it chose not to file any returns for the years involved, apparently hoping thereby to avoid both tax and penalty. Having made the choice, it must abide by it and take the consequences.

"The conclusion here reached that the statute never started to run is consistent with prior decisions that a return is required to start the period of limitations..." [Underscoring and bracketed wording added.]

71. As a result of that decision, the Association was assessed almost $23,000 for taxes covering the years 1921 through 1935, plus penalties of about $5,700.

72. In commenting on this case, Mr. Robert H. Montgomery, attorney and certified public accountant, recently wrote:14/

"Had the association filed returns each year, it would have been liable, at most, for only 3 prior years. Thus it seems advisable, even though the Treasury has ruled that an organization is exempt, to file income tax returns each year and claim the exemption. However, this rule does not apply to organizations obviously exempt which have not changed the scope of their activities."

Commissioner's Position

73. The Bureau of Internal Revenue does not encourage such filings by tax-exempt farmers' cooperatives. Under its rules of procedure returns of that type must be handled and audited much as if the filer were a taxable corporation. This is an expensive undertaking. In addition, when a return is filed under those conditions, the Bureau is forced also to reexamine the association to determine its continued eligibility for exemption, another procedure involving time and cost. Some authorities believe that if all farmers' cooperatives holding letters of exemption were to file tax returns annually for the purpose described, the resulting burden on the Bureau would be so great it is likely Congress would be urged to abolish exemption entirely for that type of organization.

Collectors' Positions

74. In some sections of the country it is understood the local collectors of internal revenue have refused to accept such tax returns, feeling they have no authority to do so. Apparently decisions on this matter are left entirely to the discretion of the individual collector. When he chooses, however, to forward such returns to Washington, D. C., they are not refused by the Commissioner's office there.

Writers' Opinion

75. In an extreme instance, perhaps somewhat like the situation described in paragraphs 68 and 69, an exempt cooperative may be justified in the filing of an income tax return in the manner and for the reason

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14/ Montgomery, Robert H. Excess Profits and Other Federal Taxes on Corporations 1941-42. 710 pp. New York, Ronald Press. See p. 50 thereof.

outlined in paragraph 67. The average association, however, may avoid any future risk of losing its exemption eligibility for any extended period if its representatives henceforth will report significant changes and refile Form 1028 periodically in an accurate and complete manner, as already explained. Cooperative managers, or their advisers, should be thoroughly familiar, of course, with the detailed requirements of the exemption law. They should keep abreast, as well, of any future changes in its interpretation.

Meeting Conditions of Both Exempt and Nonexempt Status

76. Some cooperative organizations now holding letters of exemption are conducting their legal and operating procedures in such a manner as constantly to qualify for the maximum privileges applicable to nonexempt cooperatives in computing their taxable income. This is being done as a measure of protection in the event that exemption eligibility is lost for a retroactive period.

77. How this protection applies is illustrated in part by the fact that a taxable cooperative is permitted to exclude patronage refunds from the gross income reported for taxation if it meets certain legal and corporate requirements. This includes, among other conditions, the necessity for declaring such refunds as a definite liability within the fiscal year. (See the section on nonexempt cooperatives beginning on p. 121.)

78. The precautionary measure described seems fully justified to guard against unintentional exemption violations, or even when the position of an organization is frankly thought to be uncertain.

Infractions of Rules

79. Where a cooperative association, upon a review of its operations, finds that it has failed to observe some of the exemption requirements, its best procedure is to make an immediate adjustment of the matters at fault, so far as that may be possible. It then should submit a full and complete report thereon by letter to the Commissioner of Internal Revenue (Taxpayers' Ruling Section) at Washington, D. C. Situations which are found impossible to adjust retroactively should be reported as well to the Commissioner with all the pertinent facts.

80. If the nonobservances are minor in character it is possible the Commissioner may feel they are not of sufficient importance to cause a revocation of the exemption letter. The management of associations, or their advisers, should not attempt to pass upon such matters themselves. The Bureau, only, is qualified to make the decision.

81. In corresponding with the Commissioner on exemption matters, it is always desirable to refer to the latest letter of exemption and to actually attach a copy thereof. This facilitates the Commissioner's office routine and is an important procedural custom.

Loss of Exemption; Appeals

82. When the Commissioner deems an association ineligible for exemption, he will so inform it by correspondence, revoking the letter of

exemption and stating the period for which income tax returns must be filed. It should be clearly understood, as mentioned previously, that whenever the exemption terms are not complied with - whether or not the Commissioner has knowledge thereof - exemption is lost automatically. The association, in such an event, and if aware of its noncompliance, is then under obligation to immediately report its income for taxation.

83. Some revocation rulings issued by the Commissioner, or by his deputies, are approved by the Bureau's Chief Counsel. When this is the case, the ruling letter so states, usually in a short closing paragraph. If the ruling does not carry that notation, the association, in resubmitting its case with any additional or new facts in proof of the claim for exemption, may request the Commissioner to have his ruling reviewed by the Chief Counsel.15/

84. If the result then is not satisfactory to the cooperative, it may request a review before the Bureau's local Technical Staff, which then makes a recommendation to the Commissioner. If the Commissioner's adverse ruling finally stands, the association, if desired, may appeal in the manner outlined in paragraphs 22-25.

When Tax Blanks Are Received

85. Sometimes the office of the Collector of Internal Revenue will inadvertently mail out to exempt cooperatives blank forms for reporting income or capital stock taxes. The receipt of such forms, or any others of related nature, should not be ignored. Rather, an acknowledgment should be made in a letter to the collector explaining that the organization is exempt from filing such returns, and in all cases attaching to the communication a copy of the latest letter of exemption.

15/ Mimeograph 3537 (C.B. 1937-I, 100). (1937.)

Detailed Requirements for Tax Exemption

Ten Main Conditions

86. There are at least ten fundamental conditions which must be complied with by a farmers' cooperative association that desires to secure or maintain a tax-exempt status. These requirements are summarized below for convenient reference, showing the number of the paragraph in which a detailed analysis and comment begin:

Writers' Version

87. The foregoing is not a verbatim transcription of the exemption statute itself, but represents rather the writers' interpretative version of the requirements. The exemption statute and its related regulations are reproduced in full on pages 155-161 for reference purposes.

Requirement No. 1
Operating Purposes Must Be Restricted

Statutory Restrictions

88. Section 101(12) of the Internal Revenue Code grants a tax-exempt status to cooperative associations of farmers when, among other conditions, they are "organized and operated" for the purpose of

> "...marketing the products of members or other producers..."

or for the purpose of

> "...purchasing supplies and equipment for the use of members or other persons..."

89. Obviously, if the foregoing provisions were narrowly construed, an organization would be ineligible for exemption if it engaged in any activity, however minor, which is not directly or indirectly related to the exact purposes outlined. However, it is generally recognized and accepted as practically impossible today to economically or efficiently conduct a cooperative's operations entirely within such narrow limits. Thus, farmers' associations usually have other types of activities which, when kept within certain bounds, probably will be held not to defeat the exemption privilege.

Advantageous Marketing

90. From the general trend of rulings issued to particular cooperatives by the Bureau of Internal Revenue, it is understood the term "marketing" embraces any transactions, within reasonable bounds, which facilitate the marketing or distribution of patrons' farm produce. Such transactions, it is believed, include not only ordinary expense outlays (see pars. 360-363) but the purchase and sale of equipment and supplies for storekeepers or other dealers, as well.

91. Cooperative creameries, for instance, in order to meet competition find it necessary, in some sections of the country, to purchase and then sell to their ice cream customers a line of related supplies. These include items such as cones, paper cups, spoons, and containers, flavoring extracts, crushed fruits, etc., which are usually delivered with the ice cream. This convenience is demanded by the dealer stores. In some instances even freezing cabinets are purchased and then either sold outright, rented, or leased to the store customers.

92. All of the foregoing transactions probably would be considered essential to the advantageous marketing of products. They should be handled, of course, on a cost basis. If this is not practicable and a small overage results, there probably would be no objection to its inclusion in the marketing department's savings for distribution to the association's regular producer-patrons. It is believed that the Bureau will permit these transactions to be handled entirely in the marketing department in such a way that they need not be considered in calculating either the 50 percent rule (see pars. 406 et seq.) or the 15 percent rule (see pars. 476 et seq.).

93. It is uncertain just how far the Bureau might be willing to extend this privilege. For instance, would it apply to a cooperative which, in order to meet competition, sells along with its produce items not directly related thereto? The following examples are pertinent:

A. A creamery purchases bottled orangeade, or purchases the ingredients on the open market, mixes them and bottles the finished product. The orangeade is then sold and delivered to the cooperative's ice cream customers.

B. A creamery purchases eggs from nonproducers and sells them to its regular customers, along with milk deliveries, mainly as a convenience to such patrons. (See pars. 169-170.)

Price Stabilization Efforts

94. It is rather doubtful that the principle described is broad enough to permit an exempt marketing association to engage in price stabilization operations by making purchases from nonproducers, or on the open market, of products to be marketed. (See pars. 113 et seq.) The Commissioner of Internal Revenue is known to have revoked the exemption of several associations when they engaged in an effort to stabilize prices by purchasing farm products from local dealers.

Financial Transactions

95. There seems no doubt that an exempt association may engage in financial activities such as the borrowing of funds, the payment and charging of interest, the extension of credit, etc. Those transactions normally are related to the permitted major functions of marketing and purchasing.

Processing and Service Cooperatives

96. The term "marketing" in the exemption statute is generally believed to embrace service-type cooperatives which may or may not be directly engaged in selling, but which process, manufacture, pack, or otherwise handle farm products to be marketed for producers. This includes harvesting or picking services, also the hauling of farm produce and supplies for farmers.

97. Loans to members or other patrons for crop production purposes, and the furnishing of production services such as dusting, spraying, and fumigating are permissible activities of exempt farmers' cooperatives. Associations engaged only or mainly in the latter services have been confirmed by the Bureau as exempt under section 101(12) of the Internal Revenue Code.

98. So far as can be determined, no definite rulings have been made by the Bureau to indicate any limitation on the extent to which production services may be rendered by an exempt farmers' cooperative. It is uncertain, for instance, whether or not it is permissible to render complete farming or cultivation services on a fee basis. In this class are the complete grove or orchard care and other farming operations sometimes

carried on by marketing associations for absentee farm owners. (Refer to pars. 100-103 for a discussion of basic production.)

99. Services rendered to patrons in connection with their purchases of supplies and equipment from an exempt cooperative are believed to be a permitted function. For example, a farmer buys feed corn and is then charged an extra amount for grinding of the corn.

Basic Production

100. Section 19.101(1)-1 of Income Tax Regulations 103 carries the following statement regarding "labor, agricultural, or horticultural organizations" seeking tax exemption under section 101(1) of the Internal Revenue Code:

> "...corporations engaged in growing agricultural or horticultural products for profits are not exempt from tax."

101. It seems likely that the Bureau would adopt a similar attitude toward farmers' cooperatives in deciding their right to tax exemption under section 101(12) of the Code. Probably no objection would be raised, however, where an association owns and operates, or rents and operates, a farm for a purpose directly or indirectly related to the organization's marketing functions. A pertinent example is a farm operated for experimental purposes. Another illustration is a farm operation that was forced upon a cooperative through the foreclosure or other acquisition of property which had to be taken over from a debtor.

102. The portion of the exemption statute quoted in paragraph 88 permits a tax-exempt farmer's cooperative to engage in the purchasing of supplies and equipment. In a recent unpublished ruling the Bureau in effect decided that the term "purchasing" embraced the operation of oil wells and the extraction of crude petroleum. Part of that ruling, as addressed to the oil cooperative, is quoted as follows:

> "Although you are not actually engaged in purchasing petroleum products for resale to your members or other persons, nevertheless, you are engaged in extracting crude petroleum from lands the mineral rights of which you have acquired either by purchase or lease and in selling this oil to your sole member and patron. [An affiliated farmer's cooperative.]
>
> "It is the opinion of this office that you are organized and are being operated in substantial compliance with the provisions of section 101(12) of the Internal Revenue Code, under which associations engaged in purchasing supplies and equipment for producers of agricultural products are exempt from income taxation." [Bracketed wording added.]

103. By reasonable analogy it appears likely that the basic production of any items sold as supplies and equipment under the limitations of the 50 percent rule (see pars. 406 et seq.) and the 15 percent rule (see pars. 476 et seq.) would be ruled to be a permissible activity for a tax-exempt farmer's cooperative.

Basic Manufacture

104. Such tax-exempt cooperatives may engage in the processing or manufacturing of farm products to be marketed for producers, as already explained in paragraph 96.

105. Aside from one ruling made in 1924,16/ which was not fully conclusive, the Bureau has not published any definite pronouncement as to whether or not a tax-exempt farmer's cooperative may engage in the manufacture of products sold in its supply department. However, a number of farmers' purchasing associations engaged in such manufacturing have received letters of exemption. Furthermore, since the basic production of supplies now has been ruled permissible (see pars. 102-103) there seems little doubt that the manufacture of supplies would be considered a permitted activity.

Supplies and Equipment Defined

106. The following appears on page 239 of the Bureau's Regulations 103 (see context, pp. 156-158, herein):

> "The term 'supplies and equipment' as used in section 101(12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household."

107. This broad definition apparently permits the handling of practically any items for farm or farm household use. So far as can be determined, the term "supplies and equipment" actually is so unrestricted as to include possibly any commodity, product, or article. Believed to be within the scope of that term are articles used on the person, such as clothing and other personal belongings.

108. Farm supplies were held by a recent ruling of the Bureau's Counsel 17/ to include grazing privileges furnished by an association for livestock growers. In that ruling the following observation was made:

> "Grazing is a supply to a livestock grower just as seeds are a supply to a farm, or as crates are a supply to a fruit grower."

Frozen Food Services

109. A number of cooperative associations engaged only or mainly in the renting of locker storage space for frozen foods and which furnish processing and other services related to such storage, recently applied for income tax exemption. Their right to exemption was confirmed by the Bureau under the provisions of section 101(12) of the Internal Revenue Code. Such associations, it is understood, are bound by the restriction applicable to exempt purchasing organizations in that not more than 15 percent of the rental and other service fees may originate with nonfarmers.

16/ Solicitor's Memorandum 2288 (C.B. III-2, 233).
17/ General Counsel's Memorandum 22364 (C.B. 1941-1, 296)(1941).

110. From the Bureau's action it is assumed that exempt marketing or purchasing cooperatives would be permitted to operate a locker and freeze-processing business as a side line activity. The fees received from such sources must be placed in the association's supply department when determining the extent of supply business with nonproducers under the 15 percent limitation. (See pars. 138 and 482.)

111. Where locker associations render marketing services, or buy and sell farm produce or livestock and their products, such business must be kept entirely separate from the locker-processing transactions in calculating both the 50 percent rule (see pars. 406 et seq.) and the 15 percent rule (see pars. 476 et seq.).

Nonexempt Activities

112. Very few published rulings have been made on the types of functions that would destroy an association's eligibility for exemption. It is rather difficult, therefore, to form an opinion of value on how the official bodies might rule in any particular instance. However, an organization engaged in any of the activities brought under question in this report should carefully consider the advisability of presenting a detailed outline of its operations to the Commissioner for his analysis and ruling. A particular activity, though technically ineligible, actually may not cause a forfeiture of exemption if the Commissioner should feel that it is of minor extent and importance.

Purchases from Nonproducers

113. It is believed generally certain that the marketing of farm products received from nonproducers or dealers, or the outright purchase of products from those sources, will be regarded by the Bureau as grounds for the suspension of exemption eligibility. This excepts, of course, any products so purchased for disposal by the association in its farm supply department. It also does not apply to products purchased from another exempt cooperative association, as such an organization, representing producers, is classed as a producer. If the other association is nonexempt, there is some question whether it may be regarded as a producer. (See pars. 198-201.) Another exception exists regarding business done for Federal Government agencies. (On this, see pars. 203-226.)

Emergency Purchases

114. Some unpublished cases are known in which the Bureau has permitted a small amount of produce purchases from dealers where they were clearly and fully justified as a definite emergency. The activity did not continue beyond a very short period of time, usually a matter of days, nor did it recur often. In those instances no patronage allocations nor refunds were made to the dealers, the association's net savings becoming the property of other patrons in proportion to their patronage. Nevertheless, an association might be in a better position before the Commissioner, the Board, or the Courts, if it treated such dealers on a basis equal with all other patrons. (See pars. 134-137. See also pars. 225-226A respecting Government business.)

115. In one of the few published decisions on the subject, the Court adjudged an association exempt for two particular years after the Commissioner had ruled to the contrary.18/ The decision indicated that emergency purchases from dealers were relatively minor and that no actual gain was made thereon. According to the Court, the association in one year did 5 percent of its total business with nonmember producers and nonmember nonproducers. In another year, 8 percent of such business was done. However, no separation was given so as to show how much nonproducer business was included in the named percentages. Thus, the effect of such business on the Court's decision is not clear.

116. In another decision the Board of Tax Appeals countenanced certain "commercial activities" as having an economic justification, but an income tax had been paid on that portion of the business.19/

117. Whenever associations engage in that class of business with nonproducers, regardless of their opinion as to its emergency character or justification, it seems prudent for them to immediately inform the Commissioner, setting forth all the circumstances, for his decision as to the effect on exemption eligibility.

118. No reliable guess can be offered on the amount of such activities, if any, which the Bureau would permit in any particular emergency case. It is possible that more favorable consideration might be given where an association can show that its patrons were short of products due to crop failures or other unavoidable causes, and that it was necessary to purchase from the nonproducers or dealers for reasons like the following:

A. To fill definite contracts with buyers.

B. To maintain a continuous supply of products to the markets, where interrupted delivery would impair the association's trade reputation.

C. To fill out a carload lot for immediate shipment of a perishable product, etc.

D. To meet a vital public need; for example, where a creamery's milk supply may be shut off for a short time through a cattle epidemic or as the result of a strike. Continuous distribution of the product to customers might very well be deemed in the public welfare.

Slack-Season Purchases

119. Cooperatives which operate processing or manufacturing plants on a year-round basis sometimes find that their own members or other local producers are unable to supply products in a particular period.

18/ Producers' Produce Co. v. Crooks, 2 F. Supp. 969(1932).

19/ Eugene Fruit Growers Association v. Commissioner, 37 B.T.A. 993 (1938). See further comment on this case in paragraphs 169-170 herein.

Reasons similar to those above may not exist, but such cooperatives purchase products from nonproducers so as to keep the plant running and thus absorb overhead charges.

120. Some creameries, for example, have regularly recurring slack seasons each year during which local farmers have no milk to deliver. Certainly there is a sound economic reason, under such circumstances, to make outside purchases. Whether this will be approved by the Commissioner as a permissible activity, and if so to what extent, is not known.

Purchases for Blending

121. Farmers' cooperative associations of certain types occasionally find it necessary to make purchases of agricultural products from dealers for blending with the same or similar commodities furnished by their own patrons. This is to make their products salable at higher prices, or salable at all. In one instance, an association was unable to market its patrons' honey readily unless it were combined with an entirely different variety of honey, which could not be obtained from local producers.

122. Grain elevators often have a similar situation where, for example, their inventory of wheat may average, say, a very high No. 2 grade. With the addition of a comparatively small amount of No. 1 wheat, procurable only from local dealers, their own grain easily could be brought up to an over-all No. 1 quality, yielding a much better price. Or vice versa, by adding a quantity of No. 3 wheat there could be produced a lower grade of No. 2 which, under some marketing conditions, would pay the same price as the higher grade of No. 2, thus realizing a greater return per bushel.

123. Many cooperative managers take the position that purchases of this type should be considered only as an element of processing (rather than as products to be marketed) with the accounting thereof handled as a processing expense, much as, for example, the purchase of sugar used in canning. This treatment, if approved by the Commissioner, would remove the objection to outside purchases made for the purpose of blending.

Departmental Separations

124. Purchases of agricultural products from nonfarmers are sometimes erroneously recorded by cooperatives as a part of their marketing operations. This situation exists whenever the products concerned, or an equivalent volume of similar products, are sold in the association's supply department to local producers or to other patrons. Under such conditions, the outside purchases may be properly considered as part of the supply department's functions, where they are not objectionable from a tax-exemption viewpoint. (For a more complete explanation of this subject, refer to par. 487. See also pars. 211-219.)

Nonagricultural Products

125. The marketing of nonfarm products, whether or not received from the producers thereof, undoubtedly would be held to represent a

nonexempt activity that would destroy eligibility for exemption. This includes the receipt and sale of furs, a wild-animal product; coal, a mineral product; fish and other sea products, etc. Such items, of course, may be handled through the purchasing department as farm supplies without affecting a cooperative's exempt status.

126. A Bureau ruling known as S.S.T. 203 (C.B. 1937-2, 409) held, in effect, that nursery stock, plants, shrubbery and flowers, while technically horticultural products, are to be considered as agricultural products. That ruling applies only to social security taxation but there is little doubt that it would be considered by analogy to permit the marketing of such products by an exempt farmers' cooperative.

Forestry Products

127. In deciding whether certian lands were used for "agricultural purposes," the Supreme Court of Illinois in one particular case20/ quoted a definition by Webster as follows:

> "Agriculture is the art or science of cultivating the ground, including harvesting of crops and rearing and management of livestock; tillage; husbandry; farming; in a broader sense, the science and art of the production of plants and animals useful to man, including to a variable extent the preparation of these products for man's use. In this broad use it includes farming, horticulture and forestry, together with such subjects as butter and cheese making, etc." [Underscoring added.]

128. After quoting the foregoing, the Court Remarked:

> "Unless restricted by the context, the words 'agricultural purposes' have generally been given this comprehensive meaning by the courts of the country."

129. In Illinois, therefore, lumber and timber undoubtedly would be classed as an agricultural product in matters controlled by the State statutes. So far as the Federal statutes are concerned, however, it is uncertain whether the processing of timber, together with the resulting sale of lumber for the owners of the timber, would be a permissible activity of an agricultural cooperative which is tax-exempt under section 101(12) of the Internal Revenue Code.

130. It is even doubtful that such an activity would be permitted where the timber originated from the clearing of land to be used for agricultural purposes. A few years ago, as a result of a storm emergency, some timber cooperatives were organized to clear the land. They were granted exemption as a welfare agency under the provisions of section 101(8) of the Internal Revenue Code.

20/ People v. City of Joliet, 152 N. E. 159(1926).

Barred Services

131. Contracts performed or services rendered by an association, which are not related to marketing or purchasing activities, possibly may cause a loss of exemption eligibility, particularly where the resulting income is substantial. Activities like the following are in the doubtful class:

A. Acting as a real estate or insurance agent, whether or not the association receives a fee or commission therefor.

B. Rental of an association's entire plant. It is then virtually in the rental business and loses its standing as a marketing or purchasing organization. This applies even if the plant is being used by the lessee to handle the products of the association's members. If part of the plant is rented and the amount of income therefrom is proportionately large, this may be objectionable.

C. Auto trucking not related to marketing or purchasing functions. If this is a minor activity, engaged in merely to utilize back hauling or to keep salaried drivers occupied, there is at least a possibility it might be permitted. An additional complication is involved, however, where a cooperative, by virtue of the State law, becomes a common carrier. It then may be barred under the tariff regulations from making a patronage refund on outside trucking. This probably would prevent a cooperative from meeting the exemption requirement for equal treatment of all patrons.

Commercial Activities

132. No provision exists in the Federal statutes for exemption of cooperative associations of urban consumers. (See par. 13.) Thus, perhaps as a matter of fairness, the activities of exempt agricultural cooperatives in the consumer field are confined by the statute to supplies and equipment for use mainly by farmers. (See pars. 476 et seq.) If exempt farm cooperatives were permitted to sell nonfarm products without restriction to the public at large, they would compete seriously with commercial business concerns whose prices must be set with due regard to the income taxes levied upon them.

133. An example in point is a retail dairy bar operated by a cooperative creamery primarily to dispose of part of its milk, cream, and ice cream. So far this is a legitimate marketing function, but as part of the store's activity, candy, prepared and unprepared food of nondairy origin are sold to the general public. Such sales may be considered vitally necessary for the purpose of attracting customers who also would purchase the association's regular products and by thus increasing the volume of business, there would be a resulting favorable absorption of overhead expenses. Yet, that type of business may cause an invalidation of the association's exempt status if, when combined with other supply business, the amount sold to nonfarmers, exceeds 15 percent. (See pars. 476 et seq.)

Operations at a Loss

134. There has been some feeling that if extraneous purchase, sale and service activities like those described in the several foregoing paragraphs do not realize a net saving (net profit) they are subject to less criticism. It is by no means sure that this viewpoint is concurred in by the Bureau of Internal Revenue. An opposite opinion suggests that the amount of business concerned is actually kept out of commercial channels where it might have realized a profit, which profit, in turn, would produce income tax revenue for the Government.

135. Apropos here is a quotation concerning the exemption of business leagues as taken from page 234 of Income Tax Regulations 103:

> "An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league." [Underscoring added.]

136. The first part of that sentence seems to describe aptly the main functions of a farmers' cooperative. In view of this, could the underscored portion reasonably be applied by analogy to the extraneous activities of an exempt farmers' cooperative? This is debatable, of course.

137. It is well to consider, further, that should such activities be ruled to destroy exemption eligibility, a farmers' cooperative would be subject to the Federal capital stock tax, despite the fact that its operation at a loss ordinarily eliminates the taxation of income. (But see pars. 670-674.)

Fees for Services

138. All fees received for services performed by an association must be placed either in the marketing or purchasing department, according to their proper relation, for purposes of determining exemption eligibility under the 50 percent rule (see pars. 406 et seq.) and the 15 percent rule (see pars. 476 et seq.).

139. If any such fees are unrelated to either of those departments, they must be placed in the purchasing department. There they will come under the limitations of the 50 percent rule and the 15 percent rule.

140. The payers of service fees must be considered in the allocation of savings. This is subject to the exception that if the described fees are not significantly large and do not represent a regular or normal function of an association, it is possible the Bureau would not insist on such a procedure. Under those conditions, probably no objection would arise if the savings on the fees were distributed to a cooperative's other patrons. (See par. 142.)

Extraneous Income (and Charges)

141. Where regular income,21/ extraneous to the main operating functions, such as rents, interest, and dividends on outside investments; or extraordinary (nonregular) income, such as the gain on sale of investments or other property, discount on purchase of the association's own obligations or capital shares, etc., cannot be logically attributed to either the marketing or the purchasing departments, it is believed to be exempt from classification in those departments and from consideration in calculating the 50 percent and 15 percent rules.

142. It follows also, logically, that the payers of such extraneous income need not be considered in the allocation or distribution of savings. There probably would be no objection to the division of such income between the two departments for the purpose of allocating savings to the ordinary patrons,22/ ignoring the particular payers of the income concerned. (But see pars. 380 et seq.)

143. Likewise, miscellaneous credits or charges resulting from internal bookkeeping adjustments, if not applicable to a particular department, may be divided between the departments on some logical or reasonable basis. Items of that type, of course, will not detrimentally affect the exempt status of an association.

Sale of Property

144. Farmers' cooperatives are not eligible for exemption if they engage in the buying and selling of real estate as a regular business activity. This does not apply to the incidental sale of property once used in the business, even though sold at a gain. In General Counsel's Memorandum 19465 (C.B. 1938-1, 172) the Bureau made a ruling on this point connected with exemption for social clubs. It is believed that the same principle would be held to govern farm cooperatives. The ruling is quoted in part as follows:

> "In Santee Club v. White, Former Collector of Internal Revenue, (87 Fed. 2d, 5) it was held, under section 103(9) of the Revenue Act of 1928 and article 530, Regulations 74, that the sale at a profit by a hunting club of a part of its land which had become valueless for club purposes was not such a transaction as would cause the club to lose its exempt status..."

145. Following the decision in the Santee Club case, the Bureau's Regulations applicable to social clubs were amended to add the following sentence:

> "Generally, an incidental sale of property will not deprive the club of the exemption."

21/ The term "regular income," as here used, is intended to describe items which recur year after year.

22/ The term "ordinary patrons" refers to those who deal with an association in its main operating functions of marketing and purchasing, or in services related thereto. This excludes the payers of extraneous forms of income.

146. G.C.M. 19465 is further quoted as follows:

"No general rule can be laid down to determine whether a particular sale of property is an incidental sale, but each case must be decided on its own particular facts. In the instant case the property was actually acquired for the use of the club and not for the purpose of resale at a profit... The purposes and activities of the club were not changed either before or after the sale of the property. To deny exemption in this case would be to compel an organization in order to qualify for exemption to retain property which it was unable to carry financially, and which it would probably have lost by foreclosure had the property not been sold. Under these circumstances, it is the opinion of this office that the sale of property in the instant case was an 'incidental sale' within the meaning of the above-quoted provisions of the regulations."

147. For the accounting treatment of capital gains and losses see paragraphs 380 et seq.

Allowable Amount of Extraneous Income

148. Where regular extraneous income, as described in the first part of paragraph 141, becomes substantial in annual total amount, it is possible the Bureau would declare that such activities, which are clearly of a nature not specifically authorized by the exemption statute, have reached the point of significence where they invalidate exemption eligibility. This probably would not apply to nonrecurring extraneous income or capital gains.

Are Investments Restricted?

149. In general, the investments which a tax-exempt association chooses to acquire are believed of no particular concern to the Bureau. This is subject to the exception that where an association has a capital reserve, the amount of any investments which are not directly related to the functions of marketing or purchasing, and are therefore classed as nonoperating or nonessential, would be considered in the calculation to determine whether the reserves are excessive. (See pars. 438-441 for a discussion of this calculation.)

150. In addition, if the income from nonoperating investments, whether or not the association has any capital reserves, becomes substantially large in proportion to the regular business, as outlined in paragraph 148, a question may arise that the association is straying too far afield from its exempt primary functions.

151. Some associations are investing idle funds in United States Government War Bonds, a commendable patriotic practice which should be encouraged. Others pay patronage refunds partly or wholly through the issuance of such bonds or War Savings Stamps.

Ownership of Subsidiaries

152. There is no objection to an exempt farmers' marketing, purchasing, or service association having a controlling interest in another

exempt organization. In effect, such a subsidiary merely occupies the position of an incorporated department.

153. But, if the subsidiary is not exempt from Federal taxation, a question arises as to whether the parent association's exemption may be thereby detrimentally affected. Situations of this type apparently have not been brought prominently before the Federal authorities, and it is thus difficult to form an opinion of value as to what their interpretations might be.

154. It is known that the Senate Committee on Finance once expressed itself in part as follows, regarding the exemption statute for farmers' cooperatives under the Revenue Act of 1926:23/

> "...the Treasury Department in its regulations has construed the existing law with great liberality...allowing such [exempt] associations...in some cases to operate subsidiaries, so long as the operations are not conducted on an ordinary profit-making basis." [Bracketed word added.]

155. This gives the impression that a taxable subsidiary, at least under some conditions, would be considered objectionable. If the nonexempt subsidiary's operations, when combined with those of the parent organization, produce a consolidated exempt status, there seems little reason to believe that the parent association's exemption would be impaired. Such a situation probably is rare. It could arise, however, if for example, the subsidiary were ruled taxable only because its nonmember business exceeded that done with members, yet when its transactions are combined with those of the parent organization the percentage of nonmember business becomes negligible.

156. Some cooperative authorities have the feeling that since a nonexempt subsidiary is subject to a Federal tax on any taxable income, that fact alone should end the matter and the parent association should not be further penalized by the loss of its exemption. On the other hand, it has been rather well established through a number of rulings that there is no such thing as partial exemption,24/ an organization being simply either exempt or nonexempt. Since a controlled taxable subsidiary is to all intents and purposes one and the same as its exempt parent-owner, it appears unlikely that by the simple separation of corporate identities there could be effected a virtual condition of partial exemption, which under any other circumstances is not permitted.

23/ Treasury Department I.T.-Memorandum 3886 (C.B. X-2, 164) issued July 9, 1931, quoting Report No. 52 of Senate Finance Committee, 69th Congress, 1st Session.

24/ Farmers Union Cooperative Oil Co. v. Commissioner, 38 B.T.A. 64 (1938). See also pars. 561-563 herein.

157. The following quotation is of interest although it is not cited with the intention of indicating that it definitely or positively applies to the foregoing circumstances:25/

> "...while the law is somewhat confused on the point, it may be laid down as a general rule that a parent and subsidiary relationship will be disregarded by the courts if it works a wrong to innocent third parties or to the public welfare. (Henry W. Ballantine, 'Parent and Subsidiary Corporations,' California Law Review, Vol. 14.) The courts will not recognize the distinct identity of parent and subsidiary if the one is an 'agency,' an 'adjunct,' an 'instrumentality,' or the 'alter ego' of the other - terms cited by them in describing a relationship between the two corporations which justifies them in ignoring the corporate identity of the subsidiary company."

Other Factors Concerning Subsidiaries

158. Aside from whether the mere ownership or control of a taxable corporation or association destroys exemption eligibility for the parent association, there is another factor to be considered. The net income earned by a wholly-owned subsidiary, when declared as a dividend, becomes the property of the parent. If such dividends happen to form a substantial part of the parent's income, the question of their status would then arise, as explained in paragraphs 148 and 150.

159. If the nonexempt subsidiary operates at a loss, the foregoing objection is eliminated, but another and perhaps more important one supplants it. The parent then would be using funds belonging to its patrons to defray the subsidiary's loss. The absorption of such a loss undoubtedly would be defended by a cooperative's management as a means toward the more favorable marketing of patrons' products or the more advantageous purchasing of farm supplies. Yet, an expenditure of that type might be challengeable as not within the purview of "necessary operating expenses" (see pars. 360-363) or capital reserves, the only deductions authorized by the exemption statute to be made from the proceeds of patrons' products. It seems this aspect would have considerably more force when applied to associations with a large proportion of nonmember patrons.

160. Furthermore, any amount invested by the parent in the capital of the subsidiary, or in advances thereto, might be considered as an unwarranted withholding from patrons if the capital reserves of the parent association are ruled by the Bureau to be excessive. If advances made to a subsidiary are eventually found uncollectible and charged off as a bad debt, this might be considered as outside the limits of necessary expenses.

161. The fact that a subsidiary corporation is owned or controlled by an exempt cooperative does not, of itself, entitle the subsidiary to

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25/ Montgomery, Robert H., ed. Financial Handbook. 2d Ed. 1628 pp. New York, Ronald Press Company, 1933. See p. 775 thereof.

exemption. However, a parent association's taxable status might have a bearing on a subsidiary's eligibility for exemption. Generally each corporate entity is judged on its own situation, except that the exemption of a parent association possibly may be affected by its ownership or control of a taxable corporation, as already outlined.

162. A taxable corporation receiving dividends on capital shares from another taxable domestic corporation, including a subsidiary, is taxed on 15 percent of such dividends. When received from an exempt domestic corporation, including a subsidiary, dividends are taxed at full value to a corporation which is subject to income tax.

Parent-Subsidiary Relations

163. The common conception of a parent and subsidiary relationship is expressed in the following definition: 26/

> "A parent company is an operating company that holds the stock of other operating companies. If the parent company actually controls the boards of directors of the other companies, no matter how small the percentages of the outstanding stock held, the latter companies are called subsidiaries. A corporation that merely holds some of the stock of another company, but is not in a position to dictate the latter's policy, can hardly be said to occupy the position of parent company."

164. For income taxation purposes, the Bureau's Regulations 103, pages 203-204, carry the following outline on this subject:

> "The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, of deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.
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> "The term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable

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26/ Gerstenberg, Charles W. Financial Organization and Management of Business. 840 pp. New York, Prentice-Hall, Inc., 1933. See p. 679 thereof.

or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

"The term 'controlled taxpayer' means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

"The term 'true net income' means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto)."

165. A taxable subsidiary of an exempt or a nonexempt farmers' cooperative must abide strictly by the foregoing rules. Its operating loss must not be the result of transferring an unreasonable amount of overhead expenses from the parent corporation, of insupportable service charges made by the parent, or even of sales made to the parent at subnormal prices which necessarily result in a loss to the subsidiary. The subsidiary's tax returns must be prepared as if it were operating on an independent, self-supporting basis. If it performs services for the parent, Internal Revenue Agents very likely will expect those services to be paid for at fees commensurate with ordinary commercial practice.

166. One tax-exempt corporation proposed to make an arrangement whereby the exact amount of its subsidiary's net income each year would be paid over to the parent as a rental fee for the part use of its office equipment and floor space. Such an arrangement would be easily recognized as a subterfuge, especially where the rental fee had no reasonable relation to the fair value of the lease.

Commercial Subsidiaries

167. The foregoing discussion is intended to refer mainly to a subsidiary association of a type which actually deals with farmers and operates for their benefit on some semblance of a cooperative plan. It is assumed that its ineligibility for exemption arises from some technicality which does not necessarily submerge its general cooperative nature. Where, however, the subsidiary is plainly a profit-making commercial corporation, securing its products from nonproducers as well as producers, and does not operate on a cooperative plan, there is a more serious doubt whether the parent organization may be entitled to retain its tax-exempt status. It is not certain whether the officials of the

Bureau have this particular line of demarcation in mind. The foregoing, therefore, represents entirely the writers' opinions.

168. If a commercial subsidiary of the described type disposes of some of its products to the parent organization, the latter might be considered engaged in a nonexempt activity in that products are received from a nonproducer. (For further discussion on this subject, see pars. 113 et seq., also pars. 198-201.)

Economic Need

169. The functions of nonexempt subsidiaries are often considered by cooperative managements as practically indispensable, under present-day conditions, to the efficient conduct of business. How much weight the Bureau may be inclined to give this factor of economic necessity is uncertain. There are very few recorded cases which touch upon the point. In one particular decision the following statement was made by the Board of Tax Appeals 27/ regarding an association which operated a commercial department (not a subsidiary, however) on a noncooperative basis:

> "It seems to us that all of the activities mentioned originated and were continuously maintained as incidents of the association's principal function, cooperative marketing for agricultural producers. They were, according to the uncontroverted evidence, designed to assist in the efficient performance of that function by facilitating the marketing of products, on the one hand, and by reducing the cost of necessary operations, on the other.
>
> "The encouragement extended to such enterprises by the favorable provisions of the revenue acts would to say the least be anomalous if the sacrifice of efficient operations were to be required in order to attain the statutory exemption. We find no justification for such a construction of the law or of the regulations."

170. The association concerned paid an income tax on the activities of the commercial department, yet was ruled exempt by the Board on its other cooperative operations. It is not at all likely that such an arrangement will ever be permitted again in any other case for it seems to run counter to the general rule that there is no such thing as partial exemption. Nevertheless, the quoted statement of the Board is significant in that it recognizes economic necessity. Since the Commissioner has not published his usual acquiescence or dissent concerning the Board's decision, he apparently is not bound to follow its principles.

Affiliated or Auxiliary Corporations

171. A corporation connected with a tax-exempt farmers' cooperative need not be directly owned. Through a provision in the association's bylaws, or by other express agreement with members, the latter may authorize the use of their savings for the organization or purchase of another corporation. This also could be done through direct authorized

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27/ Eugene Fruit Growers Association v. Commissioner, 37 B.T.A. 993 (1938).

deductions from the sales proceeds of members' or other patrons' products. The main association may hold the investment as a trust asset for those who contributed the funds for its acquisition.

172. Members or other patrons of the main association might directly acquire the affiliated corporation themselves, without a trust arrangement. In the case of a federated organization, the affiliate's ownership could be spread over the member-associations so that none of them had a controlling interest.

173. By proper legal steps, a cooperative now owning a nonexempt subsidiary probably could transfer ownership thereof to its members or other equity-holders. A portion of their equities could be used to pay for the transfer.

174. Under these plans any earnings of the affiliated corporation, or what might be better termed the auxiliary corporation, become the property of its owners (that is, those who contributed to its capital) and therefore do not revert to the main association. Future patrons of the latter would benefit from the operations of the auxiliary corporation, yet would have no responsibility for sharing any losses it may sustain. This is an especially important point where the normal operation is expected to result in losses. To correct this inequity, future patrons of the main association could be required, preferably through a separate agreement, to authorize the main association to deduct whatever pro rata portion of their current savings or sales proceeds is needed to absorb the loss.

175. If the Bureau should rule that the ownership or control of a nonexempt subsidiary destroys a parent's exemption eligibility, it is possible that one of the foregoing plans might not be considered in the same light. This is problematical, of course, for if two entities are owned by the same parties there is an implication of control. That is especially true when there exists a joint management and an identical or nearly identical directorate. (See par. 164.)

Agents of Cooperatives

176. The functioning of an individual or of another organization (for example, a local country store dealer) as a representative of a cooperative association for the purpose of purchasing local farm products from producers, or of selling mainly to producers farm supplies furnished by the main association, will not destroy the latter's eligibility for exemption if the arrangement is conducted strictly on an agency basis.

177. In order to fulfill this purpose, it is desirable to have an actual written agency contract which will serve as evidence of the operation's character. In addition, it is important that prices shall be set by the cooperative and not left to the discretion of the agent. Allocations of annual savings or refunds thereof on a patronage basis must be made direct to the patron himself, not to the agent. There would be no objection, of course, if the agent merely distributed to the patrons any checks for savings refunds made out by the association. It is important

that the agent should not participate in the association's savings, but rather should be strictly limited to a commission or fee basis for the services rendered.

178. If any of the patrons who deal with the local agent are not members of the main association, their transactions must be classed as nonmember business. It is desirable, of course, to bring such of these patrons as are eligible into membership. This could be done by arranging to credit their patronage refunds toward the purchase of a membership share, or toward the payment of a membership fee. (See pars. 187-188 and 247-248.)

Member Defined

179. Regulations 103 of the Bureau of Internal Revenue define a member as follows (on page 239 thereof):

> "Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such an association within the meaning of section 101(12)."

180. While this mentions only a marketing organization, it is intended to apply as well to a purchasing cooperative. The definition is somewhat misleading in the use of the term "profits," for a farmers' association eligible for exemption must operate strictly on a nonprofit basis. True, most of the successful cooperative associations aim to withhold a small portion of the business proceeds, but such withholdings actually belong to the patrons and for lack of some better title they are usually referred to as savings, underpayments or overcharges. (See pars. 227-231, 252-258, and 261-263.)

181. In the actual practice of the Bureau, the effective definition of a member is any person, association, or corporation entitled to vote in the management of the organization. The right to vote is the governing factor, not whether the member actually exercises that right. Conversely, anyone without a voting right must be classed as a nonmember from the Bureau's viewpoint, even if the association chooses to designate him as a member. (See pars. 412-414.)

182. A patron whose share of the savings is being accumulated to purchase a membership cannot be regarded as a member until he acquires the right to vote. Where such a patron actually subscribes to a capital or membership share, most associations usually extend the voting privilege to him before actual payment of the subscription.

183. In one case 28/ the Board of Tax Appeals decided in part as follows:

> "Held, producers dealing with taxpayer who did not pay the membership fee required by its articles and bylaws may not be regarded as members..."

28/ Riverdale Cooperative Creamery Association v. Commissioner, 18 B.T.A. 1159 (1930).

184. This gives the impression that an association's own rules must be followed out before a patron may be recognized as a member by the taxing authorities.

Qualifications for Membership

185. Neither the exemption statute nor the Bureau's Regulations make any direct reference to the types of persons or concerns that are permitted to become members of exempt farm cooperatives. However, this is fully taken care of indirectly through a requirement which limits the voting rights held by nonproducers. (See Requirement No. 7, page 109.)

186. There is some question whether a nonexempt farmers' cooperative may be considered as a producer-member of an exempt farmers' association. (For a full discussion of this subject, see pars. 198-201.)

Membership Admission

187. By keeping the membership fee very low, some associations make it easy for patrons to become members. A few even have arrangements whereby it is rather difficult for a patron not to become a member. This is true, for instance, where the reverse side of the form of check used by an association for payments to patrons has a notation like the following printed thereon just above the place for the patron's endorsement:

> "By endorsing this check I hereby apply for and accept membership in the _____ Association and agree to permit the deduction of 50 cents from my share of annual savings for the purchase of a membership."

188. It is believed the Bureau would offer no objection to a practice of this kind. However, some State laws prohibit this method of making patrons members.

Products of Members Defined

189. Occasionally, producer-members of a marketing association will purchase some farm products from a neighboring farmer and will market such products through the association along with and as their own. Where the association is unaware of this practice there is, of course, no obligation to do anything about it.

190. If the contrary is true, however, the association should refuse to accept the nonmember's products since they might be held technically as in the class of products received from a dealer, an activity not permitted for exempt organizations (see pars. 113 et seq.). This is on the theory that the member is actually a dealer so far as his neighbor's products are concerned. This type of situation has not been definitely passed upon by the Bureau. The products may be accepted, of course, if offered in the name of the nonmember producer, it being understood he would then receive his share of the savings. This must be accounted for as nonmember business, of course.

191. It is possible there may be extenuating conditions under which the Bureau might feel justified in permitting this practice. A typical instance would be where a member's crop failed and he is forced to purchase products either from dealers or other producers in order to fill a definite contract with the association. On the other hand, the Bureau probably would not look favorably on a situation where the patron sold his crop on the outside and then made a favorable purchase of an equivalent amount of products in order to fulfill his commitments to the association. If the membership agreement, marketing contract, or other legal papers expressly give members the right to purchase farm products and present them as their own, such a deliberate provision probably would give cause for the invalidation of exemption. (See pars. 552-553.)

192. None of the foregoing observations is intended to apply where products grown by a tenant are turned over as a rent payment to a landlord who then markets the products. Neither does it cover products raised in partnership and presented for marketing by one of the partners.

Producer Defined

193. Income Tax Regulations 103 define a producer or farmer as follows:

> "All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer."

194. The foregoing appears in a section of the Regulations which does not relate necessarily to the exemption of cooperatives. It is probable, however, that the definition would be held generally applicable to the term "producer" as used in the exemption statute. This excepts the possibility that the Bureau might rule that patrons who raise an exceedingly small quantity of farm products may not be classed as farmers in figuring the 15 percent limitation on supply business with nonproducers (see pars. 476 et seq.) and in determining the proportion of voting rights in the hands of nonproducers (see pars. 490 et seq.).

195. A person residing in a town or city, and personally inactive in farming, may be considered a producer by virtue of a farm operation conducted by his employees, whether he owns or rents the land. This is his classification for vote-holding purposes. Whether he can be considered a producer as to his supply purchases for nonfarm use, is uncertain. A farmer may raise products not handled by an association and still be classed as a producer so far as his purchases of supplies are concerned. A farmhand working for a salary may be considered a producer so far as holding a voting right in a cooperative is concerned, and also as to the purchase of supplies.

196. A feed-lot operator is not a producer with respect to his purchases of feed or other supplies for the lot, although it is possible he may be a producer as to a farm which may be located elsewhere. He is a commercial livestock dealer to the extent of the feed-lot operations. A landlord who actually does no farming but receives a share of his tenant's crop in payment of rent, is entitled to be classed as a producer 29/ and so is the tenant, provided, of course, they meet the other outlined conditions. The status of a farm landlord whose tenant pays rental in cash is indefinite as to whether he may be classed as a producer.

197. A farming corporation is a producer to the extent of produce grown by it. A dealer in produce is not, by reason of that fact, a producer. Any other groups or entities temporarily engaged in farming, for example through the operation of farm property taken over in foreclosure, are classed as producers. This would include banks, life insurance or ordinary corporations, townships, cities, counties, State or other local governmental units, Federal land banks or other Federal agencies, etc. Their purchases, however, from a cooperative's supply department of any items not actually used on the farms operated, must be considered as business with a nonproducer. This excepts business done for the United States or any of its agencies, under the conditions outlined in paragraphs 203-226.

Are Cooperatives Producers?

198. The business done with another tax-exempt farmers' cooperative, or with a tax-exempt federated farmers' cooperative, is properly classed as business with a producer, since those organizations represent producers. However, where the other organization, though it is known as a farmers' cooperative, is not exempt from Federal taxation, a question arises as to whether it may be considered a producer, or must be classed as a nonproducer.

199. No definite information is available on this subject, although it is known that exemption was approved for a federated cooperative most of whose membership is composed of nonexempt farm cooperative associations. This is tantamount to considering them as producers. That case alone, however, may not conclusively indicate a general principle for it is possible the Commissioner's decision was based on an analysis of each of the nonexempt cooperatives concerned, which resulted in the finding that they were actually taxable for minor reasons which did not essentially change their nature as bona fide cooperatives entitled to be considered as agents or representatives of producers.

200. Thus the distinction between a producer and a nonproducer organization is uncertain. Certainly there are many types of so-called farmers' cooperatives which operate on a commercial basis and therefore could not be reasonably held to represent producers, at least in the same sense that true cooperatives do. Perhaps a fair test of what constitutes a producer-organization might be not merely whether it is

29/ Farmers Cooperative Creamery Association v. Commissioner, 21 B.T.A. 265 (1930).

taxable or nontaxable, but whether a majority, or perhaps substantially all, of its ownership or control is in the hands of farmers, even though the operations may be conducted entirely on a commercial, noncooperative basis. Some limitation would have to be set, of course, on the amount of produce received from dealers, for certainly a preponderance of such transactions would clearly indicate a nonproducer status.

201. Where any business is done with nonexempt cooperatives, or where voting membership in the association is held by them, it is believed important to bring these facts to the Bureau's attention for a decision as to the effect on exemption eligibility.

Sales to Nonproducers

202. The discussion in this entire section concerning business with nonproducers is not intended to refer to an exempt association's marketing function in the sales of farm products to nonproducers. Such transactions, of course, are entirely unrestricted. Purchases of farm supplies made for and turned over, that is sold, to nonproducers are limited as described in paragraphs 476 et seq. Income for services rendered, or other types of miscellaneous income, may be received from nonproducers, but the total of such receipts is restricted as explained in paragraphs 138-148.

Business for the United States

203. An amendment made in 1934 added the following sentence to the exemption statute:

> "Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph."

204. The term "paragraph" refers to the whole of Section 101(12) of the Internal Revenue Code which concerns the exemption of farmers' cooperatives.

205. In administering the quoted provision, the Bureau has permitted the described business to be placed in a separate category from either member or nonmember business when determining the permissible amount (one-half) of nonmember transactions. (See further discussion in par. 411.) Congressional correspondence files indicate this was one of the legislators' main intentions when they prepared the amendment.

206. By this provision, business done for the Government also is removed from consideration in calculating the 15 percent limitation on supply business done with nonmembers who are not producers. (This is further explained in par. 488.)

207. What other effect is intended by this provision? Since the term "disregarded" is quite broad, some authorities believe it permits an exempt farmers' cooperative to engage in any type of business when it is done for the Government, whether of agricultural origin or not, and whether on a cooperative basis or not. The Bureau gives some

credence to that viewpoint for it does not demand that exempt cooperatives shall refund or allocate to the Government any savings (or gain) made on business done for the Government or its agencies. Instead, such savings in a particular year may be handled so as to inure to the benefit of a cooperative's other patrons in that year.

208. Considerable discussion has arisen on the exact meaning of the phrase "business done for." Why was "for" used, instead of "with"? Did Congress thereby intend to differentiate between kinds of transactions with the Government? In the opinion of the writers, the legislators probably used the word "for" because it was appropriate to the agency concept of cooperative associations. This coincides with other portions of the exemption statute in which those organizations are regarded fundamentally as agents for their patrons in the marketing of produce for them and in the purchasing of supplies for them. (See also pars. 229-231.)

209. Since the Treasury Department has ruled officially 30/ that nonagency types of farmers' cooperatives are construed to be included under the terms of the exemption statute, it seems reasonable to conclude that the term "with" is interchangeable with the word "for." This actually has been the Bureau's policy so far as the sale of supplies and equipment to governmental agencies has been concerned. Such supply sales have been classed as business done for the Government, whether or not an advance verbal or written contract existed.

210. Where a marketing association purchases farm produce outright from a governmental agency, the association taking title to the produce, this may be said to be business done with the Government. On the theory outlined in the foregoing paragraph, however, such transactions may be considered as embraced within the phrase "business done for."

211. If a representative of the Government places an order, either verbally or in writing, for a certain quantity of farm produce from a marketing association and the latter is unable to supply the entire quantity from commodities delivered by its own patron-producers, would outside purchases made by the association from commercial dealers to fill such an order, be considered as business done for the Government? Although there are no formal published rulings on this phase of the subject, certain cooperatives engaged in furnishing supplies for the war effort have been given favorable advice thereon by the Bureau recently. (See pars. 224-226A.)

212. It seems possible, at any rate, that such outside purchases of farm produce from nonproducers, or even from nonmember producers, and the resulting sale to the Government, may be considered properly as a purchasing, not a marketing, function. (See pars. 124 and 487.) There are no definite restrictions on what is to be included or excluded in the purchasing operations of a farmers' cooperative. In fact, the term "supplies and equipment" as used in the statute apparently is capable of a very broad interpretation. (See discussion in pars. 106-108.)

30/ Treasury Department I.T.-Mimeographed 3886 (C.B. X-2, 164) (1931).

213. Thus, when farm products are purchased by a governmental agency from a marketing association, there is no reason why the transactions may not be considered as a purchase of "supplies." The acquisition and sale of the products, therefore, could be handled in the association's purchasing or supply department. In that position, purchases from commercial dealers would not be objectionable. Such purchases ordinarily are not permitted in the marketing department of an exempt cooperative, as is discussed in paragraphs 113-124.

214. If the farm products sold to the Government originated with members, the association should consider the transaction as a marketing function. In that way the members furnishing products would receive a patronage refund covering the savings (or gain) on the sales. Any portion of the products sold to the Government which is determined to have originated with nonmember producers or with commercial dealers could be segregated and considered as a purchasing department function.

215. In such an event, the savings (or gain) on that portion of the transaction need not be paid to the Government but may be handled instead so as to inure to the other patrons of the supply department, or even to the patrons of the marketing department. Of course, if desired, the concerned nonmember producers and the dealers could be permitted to participate in the savings refunds or allocations based on the products received from them.

216. How the variations mentioned in the foregoing paragraph may be handled by interdepartmental transfers is shown in the following three hypothetical plans (the figures consist only of farm products sold to the United States or any of its agencies):

Explanation	Original amount	Inter-departmental transfers	Revised Amount
PLAN A			
Marketing Department			
Members' products			
Purchased by association	$ 1,000	.....	$ 1,000
Sales thereof by association	1,100	.....	1,100
Net savings after expenses			20
Nonmembers' or dealers' products			
Purchased by association	$ 500	.....	$ 500
Sale or transfer thereof to purchasing department (below)	.....	$ 500	500
Net savings after expenses			None
Total net savings of marketing department			$ 20 a/

a/ Distributed or allocated to members only.

Explanation	Original amount	Inter-departmental transfers	Revised amount
PLAN A (Continued)			
Purchasing or supply department			
Purchases transferred from marketing department (above)	.....	$ 500	$ 500
Sales thereof by association	.....	.....	550
Net savings of purchasing department after expenses			10 b/
PLAN B			
Marketing department			
Members' products			
Purchased by association	$ 1,000	.....	$ 1,000
Sales thereof by association	1,100	.....	1,100
Net savings after expenses			20
Nonmembers' or dealers' products			
Purchased by association	$ 500	.....	$ 500
Sale or transfer thereof to purchasing department (below)	.....	$ 550	550
Net savings after expenses			10
Total net savings of marketing department			$ 30 c/
Purchasing or supply department			
Purchases transferred from marketing department (above)	.....	$ 550	$ 550
Sale thereof by association	.....	.....	550
Net savings of purchasing department after expenses			None

PLAN C

Plan C is the same as Plan B except that the net savings of $30 are distributed or allocated among all those who furnished farm products. This includes member, nonmembers and dealers.

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b/ Distributed or allocated to patrons of supply department, excluding the United States or its agencies.

c/ Distributed or allocated to members, only, excluding nonmembers and dealers.

217. These three plans not only form a basis for the optional distribution of savings on Government business, but since any products sold to the Government, which were acquired from nonmembers and dealers, are transferred to the purchasing or supply department, there is no necessity for classing either their acquisition or their sale as member or nonmember business. This apparently is compatible with the expressed intention of the legislators as mentioned in paragraph 205.

218. A marketing association which pools the sales proceeds of its patrons' products could use any of the described three plans, if desired. Plan A could be effected by excluding from the pools any products sold to the Government or its agencies when such products are received from nonmember producers or from dealers.

219. From the foregoing a question arises that if farm products may be sold through the purchasing department as a supply item to the Government, what is to prevent similar treatment for sales made to other persons or entities? This is controlled to a certain extent by another exemption requirement which permits the sale of supplies to nonproducers who are not members only up to 15 percent of the total supply business. (See pars. 476 et seq.) Such limit does not apply to business done for the Government as already explained in paragraph 206.

Services for the United States

220. Entirely within the scope of "business done for the United States" are believed to be all types of services rendered for governmental agencies on which fees or commissions are paid. Some of these include processing, packing, handling, storing, marketing, and purchasing services. The latter two services refer to the situation existing where a cooperative association acts as an agent on a fee basis.

221. An example of such a purchasing service exists where a marketing association, acting as the agent of the Federal Surplus Commodity Corporation, makes purchases of farm products on the open market for price stabilization purposes. Fees are charged for this service, also for the storage of the products awaiting their disposition upon order from the Corporation. Another instance is when a cooperative makes purchases of supplies and equipment on a fee basis without taking title to the merchandise.

222. The Commodity Credit Corporation, another governmental agency, stores grain, cotton and other farm products with cooperative associations to which warehousing and handling fees are paid. Where storage or other fees are paid by governmental agencies which do not have title to the products concerned, such fees nevertheless may be considered as business done for the Government, according to informal advice from the Bureau.

223. The net savings (or gain) on service fees or commissions need not be paid to the Government agency, but instead may be allocated or distributed to the association's other patrons on a patronage basis.

Wartime Conditions

224. Many farmers' cooperatives are now processing various food products for disposal in war emergency lend-lease channels. In order to meet the required volume it becomes necessary at times to make purchases of farm produce from commercial dealers when sufficient volume is not available from producer-patrons. Other cooperatives process food commodities on a fee basis for outside dealers who then sell the finished product to the Government in connection with the war program.

Dehydration Subcontractors

225. The status of tax-exempt farmers' cooperatives which act as subcontractors in connection with the dehydration of products for the military or lend-lease program, was officially ruled upon in a letter dated October 2, 1942 from the Acting Secretary of the Treasury to the Secretary of Agriculture. The significant portion of that letter is here quoted:

"It is believed that business done by a farmers' cooperative organization otherwise exempt under section 101(12) of the Internal Revenue Code pursuant to contracts entered into for dehydrating commodities in cooperation with the Department of Agriculture, whether as prime contractor or as subcontractor, and in the furtherance of the military or lend-lease program of the United States, constitutes business done for the United States or one of its agencies within the meaning and intendment of...section 101(12) of the Internal Revenue Code and that such business would not affect the status of the cooperative organization for Federal income tax purposes."

Direct Government Contracts

226. In response to an inquiry from one cooperative, the Deputy Commissioner of Internal Revenue on November 20, 1942, replied, in part, as follows:

"It is stated that your facilities for grading, processing, packing and marketing eggs and poultry products include cold storage egg-drying equipment and a poultry cannery. Your facilities for drying eggs and canning chickens, operating on an 8-hour day basis for 40 hours per week, will handle all the products produced by your producer patrons, but by running extra shifts you could greatly enhance the output needed by the War and Navy Quartermaster Market Centers. If you increase your output for the benefit of the war effort, it will be necessary to purchase the additional eggs and poultry on the open market as there is no hope of receiving greater quantities from the producers in your territory.

You request to be advised as to whether you may purchase these additional products and process the same for Government agencies without losing your exempt status and, if so, whether you will be required to pay patronage dividends to wholesalers from whom you purchase products.

In view of the fact that section 101(12) of the Internal Revenue Code provides that business done for the United States or any of its agencies may be disregarded in determining the cooperative's right of exemption from the payment of Federal income tax, it is the opinion of this office that you may purchase eggs and chickens in the market for the purpose of filling orders on Government contracts without losing your right to exemption under section 101(12) of the Internal Revenue Code. It is the further opinion of this office that you will not be required to pay patronage dividends to the wholesalers from whom you purchase products to fill war contracts made with Government agencies."

226A. While the rulings quoted in paragraphs 225 and 226 technically cover only the subjects of dehydration and poultry operations, it seems reasonable to presume that the principle involved would be applicable to other activities, as well.

Nonfederal Governments

226B. Business done for or with local governmental units such as townships, counties, cities, states, etc., is not within the scope of "business done for the United States or any of its agencies." Local governments are not agencies of the United States.

Requirement No. 2

Operations Must Be of a Mutual Nature With Equal Treatment for All Patrons

Mutual Plan

227. A tax-exempt farmers' association must conduct its business on a mutual or cooperative plan. This requirement originates in the following language of the Federal statute which grants exemption to such associations when they are organized and operated for the purpose of:

> "...marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them..."

or for the purpose of:

> "...purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses."

228. The nonprofit, mutual nature of the permitted type of operation clearly distinguishes cooperatives from commercial business concerns whose main objective is to make profits for the benefit of the proprietor or the investing shareholders. The quoted portions of the statute have been held officially on many occasions to imply an equal treatment for all patrons, whether members or nonmembers, in transactions arising from marketing, purchasing and related functions.31/ (See pars. 232 et seq.)

Agency and Nonagency Cooperatives

229. The foregoing quotations from the statute have been construed by the Treasury Department to cover not only agency-type organizations, but also those which take title to the products received from or sold to patrons.32/ They extend as well to associations which are engaged only in furnishing services related to marketing or purchasing operations.

230. In final effect, all true cooperative organizations are regarded by some authorities as agencies. Thus, a so-called purchase-and-sale marketing cooperative which takes title to the products is deemed to have the nature of an agency since the purchase price paid to patrons theoretically represents merely an advance which is augmented at the close of the year by the allocation or refund of net savings.

231. Similarly, a farm supply organization is virtually, and in many cases actually, a purchasing agent for its patrons. Following this

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31/ For example, see Farmers Union Cooperative Co., etc. v. Commissioner, 90 F. 2d 488 (1937).

32/ Treasury Department IT - Mimeographed 3886 (C.B. X-2, 164) (1931).

theory, its so-called savings are merely the result of temporary overcharges to patrons for merchandise purchased and turned over to them.

What Is Equality?

232. As already mentioned, the exemption statute has been held officially to imply an equality of treatment for all patrons in direct business dealings. Of all the requirements, this one gives rise to the greatest number of difficulties. Precisely what constitutes equal treatment in a farm cooperative's operations is a question which is subject to a variety of opinions and interpretations. Students of cooperation who have given this matter some earnest thought usually come to the conclusion that perfect equality or perfect equity is impossible to achieve even if there existed a ready-made agreed definition therefor. In the future factors may arise to influence what might be considered equitable today.

233. Farm cooperatives in this country are using many different plans of operation. As an illustration, numerous varieties of pooling methods and pooling periods are employed. Obviously, all of these methods with different results cannot be absolutely right, nor can all of them truly represent equity. Yet they do reflect the ideas of each association's membership of what they believe to be equitable.

234. It is reasonable to assume that the Bureau of Internal Revenue will not attempt to question these detailed internal policies of exempt associations unless there is a material departure from obvious standards of substantial equity. Such equity may be concisely defined as an absence of discrimination among members 33/, or against nonmembers, in pricing, in remitting or pooling sales proceeds, in the charging of marketing commissions or other service fees, in the rate and payment of patronage refunds, and in the allocation of operating savings held in the business.

235. Although nonmembers must be permitted to share on a patronage basis in operating savings derived from business done with them, it is believed that the exemption statute does not obligate an exempt cooperative to recognize nonmembers in the distribution of nonoperating or capital gains. No rulings on this have been published, however, by the tax authorities or the courts. (For definitions and further discussion of nonoperating or capital gains, see pars. 141-148 and 380-389.)

Equality for Nonmembers

236. Sometimes a reluctance is found among the members of cooperatives toward the granting of equal treatment to nonmembers. What then is the incentive to become a member? is a question frequently heard. This is a thought-provoking query, the only answer to which is that the members have the privilege of controlling the affairs of the organization through their voting franchise.

237. The reluctance to extend equality to nonmembers has given rise to the feeling that the exemption requirements in this respect is harsh and

33/ See Farmers Union Cooperative Oil Co. v. Commissioner, 38 B.T.A. 64 (1938).

unreasonable. It should be recognized, however, that cooperatives are not forced to deal with nonmembers. They do so entirely of their own volition, on their own responsibility, and for their own purposes and ends. The original exemption law embraced orgenizations which dealt with members only, but the latter term was liberally interpreted to include all patrons. The present statute confines dealings with nonmembers to one-half of the total marketing and one-half of the total purchasing business, respectively. This is discussed further under Requirement No. 3 (see pp. 89 - 90).

238. Congress certainly did not intend through the exemption statute to confer equality of treatment upon nonmembers simply from a sentimental viewpoint. Rather, the underlying philosophy centers around the fact that unless nonmember patrons are treated equally in business dealings, their true share of operating savings is in effect appropriated by the association for the benefit of its members. Such an appropriation being considered taxable income destroys eligibility for exemption.

Superior Treatment for Nonmembers

239. In the practical administration or interpretation of the equality theory, it is possible that the Commissioner, the Board, or the Courts would not feel that exemption eligibility had been destroyed where a farmers' cooperative chose to treat nonmembers better than members in business dealings. No certainty exists on this subject, however, as apparently there are no pertinent rulings.

240. In a particular year, for instance, a cooperative's business with members yields a savings, while nonmember transactions are handled either at a lesser rate of savings, or at an actual loss. It must be presumed that the members, having control of the association, agree to or at least permit the discrimination. Thus the absorption of such a loss by an exempt association may be thought to represent nothing more nor less than an operating expense impliedly, if not actually, authorized by its membership.

241. On the other hand, a narrow interpretation of the equality theory possibly would contradict that viewpoint, particularly if the loss on nonmembers was the result of a deliberate difference in prices or service charges. Such a loss actually represents a transfer to nonmembers of amounts derived from transactions with members. The transfer, although voluntarily permitted by the members, conceivably might be considered taxable income to the association, thus destroying its eligibility for exemption. (See similar discussion concerning indirect distributions in pars. 671-674, regarding nonexempt cooperatives.)

242. In one case 34/ the Board of Tax Appeals denied exemption to a purchasing cooperative for a number of reasons, among them being the following taken from the Board's decision:

"The preferred group of patrons [consisting of three shareholders and four nonmember patrons to whom petroleum products had been sold in

34/ Farmers Union Cooperative Oil Company v. Commissioner, 38 B.T.A. 64 (1938).

large quantities] realized a saving which was tantamount to a bonus on their purchases, measured by the proportionate share of the necessary general expenses of petitioner which they would have been required to pay had they purchased on a basis of actual cost plus necessary expenses. Their share of the necessary expenses was paid by the other patrons..... The evidence negatives the fact that petitioner was operated on a cooperative basis, either as among its members alone, or as between its members and nonmembers." [Wording in brackets added.]

243. Some of the other reasons for denial of exemption were as strong or stronger than the foregoing. Thus, its real significance in the final determination is not clear. The question remains: Would the Board have denied exemption if the quoted portion of its decision had been the sole factor?

244. It is interesting to observe that Mr. Smith, a member of the Board, in dissenting, used the following language, with which Mr. Mellott, another Board member, agreed:

"I think that the petitioner has shown that it is substantially within the terms of the [exemption] statute. To its members who were other cooperatives [refers to the three shareholders mentioned above] it made sales of gasoline at cost. [Technically, they were made at less than cost.] In such case there was, of course, no necessity for crediting them with any part of the patronage dividends. The fact that those sales did not bear any part of the overhead cost seems to me to be de minimis. I think that the petitioner qualifies as a cooperative exempt from income tax." [Wording in brackets added.]

245. The association possibly may have secured price discounts according to the volume of its purchases. If so, the management might have felt that the transactions with those who purchased in large quantities could be handled at a loss because such loss perhaps was compensated by the advantage arising from a general price reduction in the association's own purchases. This possibility was not mentioned in the transcript of the case, however. It is felt that the Board's decision does not give any clear indication that exempt cooperatives may not extend to their members or other patrons price discounts for quantity transactions. See further discussion of price premiums and discounts in paragraphs 354-359.

Advantages of Nonmembers

246. Some cooperative associations have a legal structure which gives them the right to collect overpayments or other losses in connection with members' transactions. In a number of such associations, operating losses actually are collected in that manner. Even though losses are not so collectible, they nevertheless must be absorbed by existing capital equities. It is rare that any association has an agreement with nonmembers for sharing a loss on a patronage basis. In practically all cooperative associations, therefore, losses for the most part are absorbed by members. (Some recoveries, however, are made possible under the methods described in pars. 396-401.) This gives a somewhat unfair advantage to nonmembers if and when losses occur. (See also pars. 390-393.)

Many cooperatives, however, badly need nonmember business so as to provide sufficient volume for the economic absorption of overhead expenses, or possibly for the establishment of more advantageous price arrangements in the marketing of products or in the purchasing of supplies.

Building Up Membership

247. Cooperatives generally should aim to draw all of their eligible patrons into membership. The Bureau of Internal Revenue greatly aided cooperatives toward that end by its issuance of Mimeograph 3886 in July, 1931. Through that ruling exempt organizations were permitted to retain and withhold a nonmember's share of savings until it equalled the price of a membership share. (See pars. 316-317 and 321-333 for further information on that subject.)

248. It is realized, of course, that the present members of some of the more prosperous cooperatives probably do not favor the admission of new members partly on the theory that the latter get the benefit of accumulated reserves or "surplus" without paying for it. This is no longer a significant factor, however, since under the Fertile Dairy decisions (see pars. 364 et seq.) the reserves of exempt cooperatives which arise from operating savings must be allocated to patrons on a patronage basis. Thus, shareholders of an exempt cooperative may not realize upon or before dissolution from operating savings more than the par value of their shares plus dividends thereon and their respective interests in the reserves arising from their patronage, if any. This does not apply to nonoperating or capital gains which probably in most associations are the legal property of shareholders upon or even before dissolution. (See further discussion in pars. 330-393 and 512.)

Marketing Operations

249. While the exact meaning of the statutory wording quoted in paragraph 227 has not been fully analyzed and reported in any official publication, the marketing phase is partially interpreted on pages 237-238 of the Bureau's Income Tax Regulations 103. A system of pooling sales proceeds is there described in general terms, using a cooperative dairy as an illustration.

250. The statute generally is believed to authorize three basic methods of operation, namely:

A. Receipt and sale of farm products on an agency basis where the sales returns received by the association are pooled for the entire year (or for appropriate lesser periods), then paid over to those who furnished the products, less necessary operating expenses and possibly authorized capital reserves. Such payments must be made, of course, according to the unit volume and grade of products furnished by each patron.

Where a marketing cooperative operating on a pooling basis handles products which take more than one year to process and sell, pools usually are not closed until all or most of each crop is disposed of. Thus, two or more crop pools may be in operation simultaneously. In

such a case it is important to make fair and reasonable allocations of yearly expenses between the pools.

Individual farmers must secure permission from the Commissioner in order to compute their own taxable income upon the crop basis. Of course, they still must file an income tax return annually. (See pp. 35 and 188 of Income Tax Regulations 103.) It is believed that by analogy exempt cooperative associations would be permitted also to operate on the crop basis, if they so desired. However, since no rulings have been published on this subject, it appears desirable for both exempt and nonexempt cooperatives which operate in that manner to report the facts to the Commissioner for his approval. (See pars. 265-267 and 668-669.)

B. Receipt and sale of farm products on an agency basis where the sales returns received by the association are accounted for to each patron according to the actual price received for his particular products, less necessary operating expenses and possible authorized capital reserves.

C. Outright purchase of products from members and other producers at prices which do not discriminate among members, or between members and nonmembers, which prices are intended to provide a reasonable margin for the payment of necessary operating expenses and possibly for the setting aside of authorized capital reserves.

251. It is believed further that the statute implies an equitable distribution of marketing or operating expenses among patrons. This is construed not to mean a mere arithmetical division of expenses according to the unit volume of products handled, but rather a fair apportionment of expenses based on the actual conditions of handling and sale. This permits the charging of a different fee, if fair and equitable, for each type of service performed. (See pars. 354-359.)

Marketing Accounting

252. Particular types of associations, notably creameries, are able to pool their total expenses periodically, along with a pooling of sales proceeds. This is usually done strictly according to unit volume (pounds of milk or cream) and grade (butterfat content) of products. Other types of cooperatives find it more practical to assess a marketing service charge against each unit or particular lot of product, or to charge a commission based on a fixed percentage of the sales return value of patrons' products.

253. Another system in use is the making of an advance or series of advances throughout the crop season on products received. The amount not so advanced and therefore withheld from the producer is analogous to the service charge or commission described. In cooperative accounting theory all such withholdings are merely a temporary expediency to cover the estimated cost of operation.

254. At the close of accounting periods these withholdings are adjusted to the actual cost of operation through the refund or allocation to all patrons of any net proceeds or savings which may remain after provision for limited dividends, if any, on capital shares. Since normally most or all of the so-called savings are actually the balance of proceeds from the sale of patrons' products, the outlined procedure for the equitable distribution of sales proceeds applies with equal force to the handling of savings. It also appears desirable, if not necessary, that any miscellaneous or extraneous income arising from sources other than the proceeds of sales be distributed on an equitable basis. (For a further discussion of such income, see pars. 141-148 and 380-393.)

255. Some marketing associations, by pooling all sales proceeds and all expenses, have no "net income" nor savings to record on their books. Their working funds usually are derived from capital contributions. These may be directly paid in or may arise through authorized deductions from the sale proceeds of each patron's products. Working funds are often derived also from the sales proceeds temporarily held until pools are closed or paid. It is the usual practice, of course, to pay producers a substantial advance on an estimate of what the final proceeds will be.

Purchasing Operations and Accounting

256. The statutory provision quoted in paragraph 227 obligates an exempt organization engaged in the purchasing of farm supplies to conduct its business on a "cost" basis except, of course, for necessary reserves and for dividends on capital shares. Since the determination of actual cost usually is made only for an extended accounting period (not beyond a fiscal year) purchasing cooperatives, in the interim, set their billing prices so as to include enough margin for the defrayment of operating expenses, estimated on a high basis. Thus, normally the price contains a deliberate overcharge, so-called. At the close of the accounting period, this overcharge, often termed net savings, should be allocated to all patrons on an equitable basis.

257. As mentioned in the case of marketing associations, it is believed that the law did not intend to prohibit variations in the apportionment of expenses among patrons, so long as such variations can be justified by actual differences in handling or other operating costs. For illustration, price discounts for large purchases by patrons should be permissible since undoubtedly the merchandise concerned could be acquired and handled by an association at a lesser cost per unit than is the case for smaller transactions. (See pars. 354-359 for further information regarding discounts.)

258. On the other hand, it is important to keep in mind that the statute unmistakably implies an equality among all patrons in business dealings. Thus, theoretically, the margin between the base purchase cost of merchandise and the value at which it is billed to patrons should be kept as nearly uniform throughout an accounting period as it is possible to achieve, outside of uncontrollable factors such as the effect of competition, or the effect of an unforeseen decrease in business volume, etc. (For a further discussion of margins, see pars. 349-351.)

The Term "Income"

259. No attempt will be made here to define the general meaning of the term "income." That has been done on many occasions by competent authorities. One excellent definition appears on pages 28-29 of the Bureau's Income Tax Regulations 103. Farm cooperatives entitled to exemption have no taxable income, of course. The proceeds received from the sale of products by an association operating on a pooling basis are not income. That term probably should not be applied, either, to the main transactions of a so-called purchase-and-sale cooperative. (See discussion in pars. 229-231.)

260. Nevertheless, amounts received by a cooperative association from sources outside of their main functions of marketing and purchasing, and not related thereto directly or indirectly, are believed to be appropriately termed "income," or "extraneous income," especially where the payers thereof do not expect nor receive patronage refunds thereon. (For a further discussion of extraneous income see pars. 141-148 and 380-393.)

The Term "Savings"

261. As mentioned in paragraph 255, cooperative associations operating on a pooling basis have no "net income" or net savings beyond what may be represented in extraneous receipts or gains. Other cooperatives, however, operating by means of service charges or selling commissions, and purchase-and-sale organizations engaged in either marketing or supply functions, usually have overages when successfully operated. In the absence of a better name, such overages are termed "savings" in this publication.

262. The overage or savings derived from the chief functions of marketing, purchasing and their related activities are designated herein as "operating savings." This only includes the amounts which originated from transactions on which patronage allocations or refunds must be made in order to maintain a tax-exempt status. (See par. 381.) It does not include extraneous income or charges of either a regular or extraordinary type, as described in paragraphs 141-148 and 380-393. The sum of operating savings, plus extraneous income and minus extraneous charges, equals the "total net savings," usually referred to herein as "savings."

263. The distinctions outlined are necessary for a proper understanding of this report. It is fully realized that small cooperative associations do not have available the accounting facilities to make such differentiations. Furthermore, it is not intended by any of these remarks to imply that fine accounting distinctions are a requisite to the maintenance of a tax-exempt status. (See also pars. 418-422.)

Savings Allocations

264. Exempt marketing and purchasing cooperatives are required to allocate their net operating savings, if any remain after providing for limited dividends on capital shares, on an equitable basis among all patrons, whether members or nonmembers. This allocation must be made according to the proportionate business transacted with each patron, measured by product units (pounds, bushels, boxes, etc.) or dollar value. This is termed the "patronage method"; no other plan of allocation is permitted for an exempt

cooperative. All net savings, from ordinary operations, whether they are to be refunded or reserved, must be so allocated. (See pars. 368 et seq.) This excepts extraneous and capital gains, particularly those of large size. These are discussed in paragraphs 141-148 and 380-393.

265. It is necessary to make the foregoing allocations at least once annually, preferably at the close of each fiscal year. There are a few cooperatives whose memberships believe that equity is better served by allocations which are based on the business and savings of two or more years combined. No published rulings are available to indicate whether or not this procedure is permissible for an exempt cooperative. It possibly may be objectionable to the Bureau since a cooperative's patrons are taxable in terms of yearly income. (A nonexempt cooperative is not permitted to reduce its taxable income in a particular fiscal year by patronage refunds which did not arise from the business and savings either of the same year or of the preceding year. See section beginning on p. 121 .)

266. The foregoing paragraph is intended to refer only to the type of cooperative whose operations may be based conveniently and effectively on a yearly period. It does not refer to marketing associations that handle products which take longer than year to process or to sell. Generally those organizations operate on a pooling basis as is discussed in paragraphs 250A, 255, and 261.

267. It is obvious, of course, that even though a cooperative may choose to combine several years' savings for refund purposes (assuming that exempt cooperatives are permitted to do so, which is uncertain) or may have pools which are not completed within one year, it should nevertheless close its general accounting records at least once annually and so determine its savings, if any, by years. (Nonexempt cooperatives must report their net income for taxation in terms of each fiscal year. See pars. 668-669.)

Allocation Bases

268. The percentage of each patron's transactions to the association's total transactions should be used as a basis for dividing or allocating the net savings where the association records do not show the gross margins 35/ on the transactions with each patron. (See pars. 269-273.) Some permissible measurements of total transactions are as follows (other equitable methods probably are in use, or could be devised):36/

For a Marketing or Bargaining Association

Where an Association Takes Title to Products:

A. Units and grades of products purchased from patrons.

35/ By gross margin is meant the difference between the purchase cost to the association and the amount at which the produce or merchandise is sold.

36/ For determining the volume of business under the 50 percent rule, see pars. 406 et seq., and under the 15 percent rule, see pars. 476 et seq.

B. Dollar amount of products purchased from patrons.

Where an Association Does Not Take Title to Products:

C. Units and grades of products marketed for patrons.

D. Dollar amount of marketing fees or commissions assessed to patrons.

Both Types of Operation:

E. Where an association makes outright purchases of products and also markets on an agency basis, these two activities should be accounted for separately as subdepartments. Each subdepartment, with its own net savings, then uses its own basis for the measurement of business volume. (See pars. 247-280.)

For a Service Association
(Such as fruit processing, packing and shipping, but not selling)

F. Units and varieties of products handled or processed for patrons. This basis should be used only where the packaged units are uniform or are convertible to a uniform standard, or where different classes of units are separately accounted for as subdepartments, with net savings for each arrived at through the use of sound accounting principles.

G. Dollar amount of packing or other service fees assessed to patrons.

For a Purchasing Association

H. Units of supplies purchased and turned over to patrons.

I. Dollar amount of supplies turned over to patrons, at purchase cost to association.

J. Dollar amount of supplies turned over to patrons, at price billed to patrons.

Gross Margin Method

269. Some types of cooperatives which operate on the purchase-and-sale basis keep their accounts so as to show the gross margin obtained on each patron's transactions. This kind of accounting is practicable mainly for certain classes of purchasing organizations which are able conveniently to determine the base purchase cost to the association of each article of merchandise supplied to individual patrons. For such an organization, the difference between the described base cost and the price at which the goods are billed to patrons is the gross margin.

270. Where each patron's gross margin is know it may be used as a primary base for the determination of net margin or net savings for each patron. This is done by dividing the operating expenses among all patrons in an equitable manner and deducting each patron's share of expenses from the known gross margin on his transactions.

271. The expenses may be allocated among patrons in the same proportion as:

A. Each patron's purchases by units of merchandise bear to the total units purchased by all patrons. This method, of course, is usable only when the units are uniform and involve only one kind of merchandise. Each type of merchandise could be acccunted for through separate departments. (See pars. 274-279.) Or, as

B. The billing price to each patron bears to the total billing price to all patrons. Or, as

C. The purchase cost to the association of each patron's purchase bears to the total purchase cost of purchases made by all patrons. Or, as

D. The gross margin on each patron's transactions bears to the total gross margin on the transactions with all patrons.

272. Where a considerable variation exists within a particular accounting period in either the purchase cost per unit to the association or in the billing price per unit to the patrons, methods B, C, and D may not be equitable judged from one viewpoint. Under some conditions each of the foregoing procedures would yield a different result. Choice of a particular method actually depends upon the kind of equalization desired by an association's membership. It is believed that any of the listed methods will be approved by the Bureau for an exempt cooperative association.

273. None of the foregoing is intended to preclude the charging to patrons of special or direct expenses incurred in connection with their particular transactions. The most common items of that class are delivery charges which, of course, may be assessed in accordance with the actual service rendered.

Departmental Accounting

274. There are no published rulings to indicate that the Bureau will be concerned as to whether savings allocations or payments are made by an exempt association on a single basis, or are made according to the actual results of the marketing department and purchasing department separately, or by subdepartments thereof, or by branches situated at various locations.

275. In an unpublished ruling made by the Acting Deputy Commissioner of Internal Revenue early in 1941, one cooperative association was permitted to handle savings refunds on a different basis at each of its branch stores. That ruling is quoted in full as follows:

"Reference is made to your letter of December 12, 1940, in which you state that a central cooperative association which has been held to be exempt from Federal income tax operates a number of different branch stores. The records and books of each separate branch are maintained so that the profits of each branch can be readily determined. One of the branches in a certain trading area can pay patronage refunds to its patrons; a branch in another section which has operated at a profit

does not pay a patronage refund to its patrons because the profits are retained to furnish additional facilities; another branch has not made a profit; and another branch operated at a loss and is not able to pay patronage refunds to its patrons. You request to be advised as to whether each one of these branches can operate as a separate unit in the payment of patronage refunds without affecting the exempt status of the cooperative association.

"It is the opinion of this office that a cooperative association which operates several branch stores, some of which have operated at a profit during the year while others have operated at a loss, may distribute patronage dividends only to the patrons of those stores which have operated at a profit without affecting its exempt status under the provisions of section 101(12) of the Internal Revenue Code.

"It is also the opinion of this office that a cooperative association which operates several branch stores may retain the profits of one or more of its branches rather than distribute them as patronage dividends, provided such profits are retained for a necessary purpose within the meaning of section 19.101(12)-1 of Regulations 103, without affecting its exempt status."

276. By reasonable analogy the foregoing probably could be considered as applicable to individual departments as well as to branch locations. (See par. 318.)

277. The retained savings mentioned in the quoted ruling must be allocated to each patron on a patronage basis in accordance with the procedures outlined in paragraphs 368, 369, etc. Furthermore, the net savings by branches or departments must be determined, of course, only through the use of sound accounting principles, particularly in the apportionment of overhead and indirect expenses.

278. It is believed that equity is best served by the allocation of savings on the basis of a separate accounting for each department or branch. This could not be done, of course, by organizations incorporated under State cooperative acts which permit only a single basis of distribution. It is recognized that there may be situations where the cost of keeping such records would outweigh the advantages to be gained.

279. In publications expected to be issued later, an outline will be made of the detailed accounting methods believed permissible for tax-exempt cooperatives, regarding various plans of pooling, savings allocations by product units, by dollar amount, by departments or branches, etc. This will include recommended procedures for the apportionment of expenses to various departments.

Departmental Illustration

280. Taking as an example an agency-type fruit packing and marketing organization, which also operates a farm supply business, the following illustrations are given of methods believed to be permissible for basing

the business volume on which each patron's proportion may be calculated for the purpose of allocating savings:

By Single Departments

For Allocation of Marketing Department Savings to that Department's Patrons Alone:

C or D basis, as described in paragraph 268.

For Allocation of Packing Department Savings to that Department's Patrons Alone:

F or G basis, as described in paragraph 268.

For Allocation of Farm Supply Department Savings to that Department's Patrons Alone:

H, I, or J basis, as described in paragraph 268, or gross margin method, as outlined in paragraphs 269-273.

By Combination of Departments
(Such combinations should be used only where net savings are not recorded for each department)

For Allocation of the Combined Savings of the Marketing and Packing Departments to the Combined Patrons of those Departments:

K. Dollar amount of marketing fees or commissions assessed to patrons plus dollar amount of packing or other service fees so assessed.

Note: In this instance the unit volume of products handled for patrons could not be used as a basis, since some patrons might have had packing done for them, but no marketing.

For Allocation of the Savings of the Entire Association to All of Its Patrons:

L. Dollar amount of marketing fees or commissions assessed to patrons plus dollar amount of packing or other service fees, plus dollar amount of gross margin realized on farm supply transactions.

Note: The foregoing method is usable only where the gross margin is known on each patron's transactions with the supply department. Where the records are not kept in that manner the following alternative method may be used:

M. Divide the net savings of the entire business between the three departments, according to the following proportions, that is, the percentage of each to item 4:

1. Marketing fees or commissions
2. Packing or other service fees

3. Gross margin on supply operations
4. Total of the foregoing

then allocate the estimated savings of each department, so arrived at, to the patrons of each department.

Some Unallowable Methods

281. Some procedures for the allocation of savings which are believed inequitable and which, therefore, probably would warrant or require the disapproval of the Commissioner of Internal Revenue for use by tax-exempt cooperatives, are as follows:

A. Methods which ignore some of the patrons, or a certain class of patrons, or the patrons of a particular department of the business. This embraces the practice where, for example, the patrons of two departments share all the association's savings, which include the savings of a third department. If any of the latter department's patrons also deal with the other departments, they, of course, participate in the third department's savings, but such participation does not properly recognize the exact proportions of their entire patronage.

Such a method possibly might be permitted where the third department's business and savings are quite minor, or where most or all of its patrons deal with the other departments in substantially the same proportion as their business with the third department.

The foregoing is not intended to refer to the situation where a particular department has a loss. This subject is treated in paragraphs 282-284 below.

B. Any method based on departmental savings, where overhead and indirect expenses are not distributed between departments on a reasonable and sound accounting basis.

C. Any method not based on proportionate patronage or proportionate gross margin.

D. Any method with an illogical or incongruous basis such as, for example:

1. Adding unlike units of products or supplies.
2. Combining such factors as marketing commissions received, with the value of purchases made from patrons.

Where One Department Has a Loss

282. Where, for example, the packing department and marketing department operations each result in a net savings, but the farm supply department has a net loss, a permitted procedure for basing the allocation of

savings is to deduct such loss from the savings of the other two departments in a proportionate manner, as illustrated in the following table:

Net Savings:	Amount	Percent
Marketing department	$4,000	80
Packing department	1,000	20
Subtotal	$5,000	100
Deduct: Farm supply department loss	1,000	
Total net savings	$4,000	
Net Savings for Allocation Purposes:		
Marketing department patrons	$3,200	80
Packing department patrons	800	20
Total net savings	$4,000	100

283. By this method no allocation is made to the patrons of the farm supply department. If desired, however, the association could allocate that department's loss to the patrons dealing with that department, as explained in paragraphs 396 et seq.

284. Under the cooperative acts of some States, only one general patronage refund is permitted. Thus, in the foregoing example, the patrons of the farm supply department would participate also in the allocation of the net savings of $4,000, despite the fact that a loss was sustained on the supply operations.

Minor Net Savings

285. At times, an exempt association's total net savings for a year may be very small. Often, particularly if there are many patrons, the division of a very small sum among them is either impractical, or yields an inconsequential result. In such instances it is likely the Bureau would not object if the association did not make an actual allocation of the minor savings, but instead chose to let the savings stand on the books for distribution upon the eventual dissolution of the organization. In the meanwhile, such savings could be carried in an account entitled, for example, "Savings to be allocated to patrons of the _____ season."

286. It seems reasonable to avoid the expense of making actual allocations whenever they would average say less than a dollar each for most of the patrons. Whether or not the Bureau would agree with that particular limit is uncertain. The limit, of course, should be set far below the lowest average amount per patron which the association realizes from its year-to-year normal operations.

Minor Patronage

287. Some exempt associations have adopted the practice of not allocating savings to any patron whose business during the year did not equal a specified minimum amount. It is possible this may be held by the Bureau to destroy exemption eligibility. A safer procedure is to make savings allocations to every patron, however small his business may be, but to actually send out refunds only when the amount thereof, is above a certain minimum. This minimum should not be set at an amount appreciably greater than an estimate of the cost of distributing the refund. Perhaps one dollar would not be too high under most circumstances. Amounts below the selected minimum might be offered for payment upon personal call from patrons.

288. Such withheld savings should remain credited to the patron-owners until dissolution of the association, awaiting their demand for payment. If it is burdensome to maintain an individual account of this character with each of the patrons concerned, the total amount of such credits could be grouped in one account. In that case a complete list of the payees with the amounts credited to them individually should be kept so that payments may be made if called for.

289. Credits of this nature to patrons who cannot be located may be handled as outlined in paragraphs 336-337.

290. While the foregoing procedures have not been ruled upon officially, it is believed the Bureau would not object to them.

Proved Purchases as Basis

291. Supply cooperatives, particularly those in the gas and oil business, sometimes put the burden of record keeping on their patrons by having a rule that savings shall be apportioned or paid only to those who present sales ticket copies to prove their purchases. This clearly destroys exemption eligibility, 37/ as it does not provide equal treatment for all patrons and because the Bureau's Regulations stipulate that patronage records must be maintained and preserved by the association. (Such records are discussed further in pars. 467-475.)

Payers of Miscellaneous Income

292. The procedure for allocating savings to those who pay service fees, nonoperating, extraneous, or miscellaneous income to a farmers' association is discussed in paragraphs 138-148 and 380-393.

Transient Trade

293. The trade of an oil association, or of any exempt supply association, with nonfarmers, tourists, or transients must be handled on a basis equal with the treatment accorded members in the allocation or payment of patronage savings, etc. This represents a considerable burden on the association as the name and address of each such customer must be listed along with the amount of his purchase. Many associations with a large

37/ See ruling in the case of Central Cooperative Oil Association v. Commissioner, 32 B.T.A. (1935).

amount of this business have found it impractical or too expensive to comply with this requirement and, therefore, have decided to forego an exempt status.

294. Since the sale of gasoline and oil to transient motorists may be thought to represent somewhat of a civic necessity, at least under some local conditions, and because of the described burden of record keeping, it seems possible that if the total amount of such business in minor the Bureau might not object if the concerned patrons were excluded from participating in the refund of savings. While no rulings have been published on this subject, it is believed that if the amount of business handled in this manner were kept within say 5 percent of the total supply business, an issue on the matter might be avoided.

295. If permitted at all, the Bureau probably would look with less objection on this situation if the gain on such business were allocated or distributed to an association's other patrons on a patronage basis, rather than allowing it to inure to the benefit of the holders of capital shares. The bylaws of some oil associations indirectly accomplish that result by providing that any gain realized on transient or tourist business must be credited to a special reserve to be expended for cooperative educational purposes. (See further discussion of educational fund reserves in pars. 433-435.)

"Double" Refunds

296. At times, an exempt marketing-purchasing cooperative may find it desirable to pay two patronage refunds on an identical product - one on its purchase and another on its sale. This comes about when, for example, corn is purchased in the marketing department from local producers and is sold in the supply department as feed to another producer. Ordinarily, the transfer of such an item from the marketing to the supply department should be done at a price commensurate with what the latter department would have to pay in the open market. This permits the marketing department to "earn" its proper margin.

297. In such cases it is believed the Bureau will permit an association to exercise its option as to whether a refund should be paid in the marketing department or in the purchasing department, or whether two refunds should be paid, that is, one for each department. (See par. 487.)

Form of Savings Distribution

298. A farmers' cooperative is not required by the exemption rules to distribute in cash any part or all of its annual savings which may remain after limited dividends, if any, on capital shares. Savings may be retained in the business as a capital reserve. This is subject to the exception that such a reserve will not be permitted to accumulate beyond a reasonable amount. (See pars. 416 et seq., particularly pars. 438-445.) Savings retained as a reserve must be allocated on a patronage basis and credited to each patron's account. (This procedure is explained in pars. 368 et seq.)

299. When savings are so handled by an association, the allocated reserves usually are not payable before dissolution. Some cooperatives, however, prefer to set them up with a long-term maturity, or on a revolving basis. (See pars. 462-463.) It is not essential that certificates be issued to evidence such reserves. In fact the existence of certificates brings about an awkward situation where impairment of the reserve becomes necessary to absorb an operating loss. If, despite this, it is considered desirable to have certificates, they normally should not be transferable except with the approval of the association. (See pars. 314-315, 376, and 522-528.)

300. Savings may be distributed also in the form of written instruments such as notes or bonds and certificates of indebtedness, investment, equity, capital stock, or of other capital shares. Most associations prefer to issue such obligations or such shares in nonnegotiable or nontransferable form, without interest and without a fixed maturity. This avoids possible future embarrassment to the organization.

301. Payment of savings may be accomplished by capital equities which are not evidenced in writing. A resolution of the directors could bring this about if the legal foundation of the association so authorizes. Such uncertificated shares differ from the allocated reserves described in paragraphs 298-299 in that the latter are usually subject to reduction for the absorption of future operating losses, while capital shares normally do not absorb losses until dissolution. (See pars. 636-637 on the nature of capital reserves. See also par. 371.)

302. Another permitted procedure is to set up the savings as a patronage refund payable (liability). Such refunds could be declared due at a definite future time of either short or long term. They also could be made payable at an indefinite time, or in the discretion of the directors, or upon dissolution. When handled in one of the ways just indicated, the so-called refunds actually become tantamount to capital shares or equities. Likewise, any other savings credits without a definite maturity, whether or not evidenced in writing, would have a similar status. (See discussion in pars. 522-528.)

303. It is possible also to pay a savings distribution in the medium of property owned by an association. Some types of property, as for example investment shares of another concern, lend themselves to this possibility. With others, this is not feasible.

304. A number of farmers' cooperatives today with fine patriotic zeal are purchasing United States Government War Bonds and Stamps for use in payment of savings distributions. It is hoped that there will be a wider adoption of this practice.

305. Proper authority for the form of savings payment selected by a cooperative association should appear, of course, in its bylaws or other organizational and legal papers; if not, the patrons might decline to accept noncash settlements. The distribution also must be consistent with the State statutes under which an association operates.

Effect upon Income of Patrons

306. Members, whether individual producers, corporations, or other cooperative associations, which report for Federal income taxation on the accrual basis, should enter as an asset their portion of any of the savings distributions described in the foregoing paragraphs. A corresponding credit should be made on each member's records to the same account which was charged or credited through the original transaction with the association. If the savings refund is credited by the member so as to increase the sales return on his products, or to reduce the cost of his farm operating expenses (where, for example, his farm supply purchases were charged to such expenses), then the refund will cause an increase in the member's taxable income if his total income places him in the taxable class. If, however, his supply purchases were used, for instance, in the construction of a farm building, then the savings refund on such purchases would be credited to the building cost and would not affect the member's taxable income.

307. Savings distributions must be so entered and handled by members reporting on the accrual basis whether the distribution is made in the form of cash, as a debt evidenced or not evidenced in writing, as a share of a capital reserve, in capital stock, or in other certificated or uncertificated capital shares or equities. This applies also to nonmembers except that the latter probably would not be required to report for Federal taxation any capital equities which they have not agreed to accept and which are declined. (See also pars. 650-651.)

308. Where patrons file their Federal tax returns on the accrual basis, when should they report their share of savings? The Bureau has answered this for the members of exempt religious associations as quoted below from page 242 of Regulations 103. By analogy this probably would be held to apply also to exempt farmers' cooperatives and their patrons.

> "If the taxable year of any member is different from the taxable year of the association . . . the distributive share of the net income of the association . . . to be included in the gross income of the member for his taxable year shall be based upon the net income of the association. . . .for the taxable year of the association . . . ending within the taxable year of the member." [Underscoring added.]

309. If a patron later finds that any of the described distributions which he reported for taxation have become uncollectible or worthless, he has the privilege of deducting such items from his taxable gross income of the year in which they are determined to be worthless. The taxpayer is obliged to show proof of such determination. If the patron later realizes any amounts on the items written off he must report them for taxation in the year of realization.

310. Members or other patrons reporting for Federal income taxation on the cash basis of accounting ordinarily are not required to report their savings shares until the latter's actual receipt in cash, where constructive

receipt of cash is involved. Such receipt is defined in general terms on page 190 of Regulations 103, as follows:

"Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition."

311. Constructive receipt of cash probably exists where a cooperative makes a savings distribution in the form of capital stock or other capital shares or equities. Ordinarily the authority to make those types of distribution appears in the organization's bylaws, thus constituting an express agreement with members. Although no formal rulings have been published on the subject, Bureau officials have indicated verbally that a constructive receipt is here involved. This is on the theory that the members accepted the capital equities voluntarily in lieu of cash.

312. The capital shares or equities of many associations cannot be readily sold by holders. Furthermore, certificates often are issued in nonnegotiable or nontransferable form. Whether these factors will affect the Bureau's determination of constructive receipt is uncertain. As mentioned in paragraph 307, nonmembers probably would not be required to report as income any declined capital equities which they did not agree to accept.

Amount Reportable by Patrons

313. Any distribution of savings made in noncash forms, including capital shares, may be reported by patrons for their own Federal income taxation at a value which represents their appraisal of its realizable worth. When such appraisal is less than the face value of the distribution, the taxpayer patron probably will be required by the Bureau to show proof of the basis of valuation. A discounted value probably could not be justified if the association issuing the distribution was considered by the Bureau to be in a sound and liquid financial condition.

Notification to Patrons

314. The Bureau does not require that patrons be notified of any allocated savings or declared refunds, etc., placed to their credit. Nevertheless, it is believed a good cooperative policy actually to make such notifications whenever feasible. A simple statement sent at the close of each year to each patron showing the year's increases or decreases in his equity, and the balance thereof, is desirable.

315. Of course, it is recognized that particular local conditions may sometimes dictate otherwise in the judgment of the management. Any member's demand to know the amount of his particular equity could not be

legally refused. The right of a nonmember to enforce such a demand probably depends upon whether or not the association had an agreement with him to that effect.

Equality in Payment

316. When savings of the current year, or of prior years, are to be distributed, they should be handled so as to avoid discrimination among patrons. The following methods of distribution probably would not cause any conflict with the exemption requirements:

A. Immediate or deferred cash payment to all patrons, including nonmembers. Shares of small amount may be handled as described in paragraphs 285-290.

B. Immediate or deferred cash payment to members, crediting the nonmembers' portion of savings toward payment of the minimum capital share or fee necessary for membership at the par value or at the book value thereof. This eventually brings eligible patrons into membership, if their savings become sufficient and if they are willing to become members. (See pars. 321-322 and 324-335.)

This brings up the question: May an exempt association increase the minimum monetary requirement for entrance into membership? Would this be considered unequal treatment? No published rulings have been made on this point. It is believed, however, that the Bureau would not object to such an action provided all newcomers within a particular fiscal year were treated uniformly. It is possible that if the new entrance requirements were unreasonably greater than the former ones, the practice might be deemed inequitable.

C. Payment through issuance of capital stock or other capital shares, certificates of equity, notes, bonds, etc. to all patrons.

D. Payment to nonmembers in cash or as a short-term liability, while members are paid for their portion through the issuance of capital shares. This rather anomalous practice is sometimes followed by associations as a means of attracting nonmembers whose volume of products may be needed, for example, to supply a definite market demand and to assist in the absorption of overhead expenses.

317. Some of the foregoing methods may conflict with State laws. For instance, associations incorporated in some States may not pay savings in cash to nonmembers, but must apply them toward the purchase of a capital share; other States do not permit any type of savings refunds for nonmembers.

318. Sometimes patronage refunds are paid in cash for one department, while the savings of other departments are merely allocated to patrons for definite or indefinite future payment. Ordinarily, it is equitable to base cash refunds on a uniform percentage of each department's savings. This is particularly true where gross margins retained are somewhat

uniform for each activity. Variations from this practice may be justified, however. One department, for instance, may involve greater financial outlays or greater operating hazards than the others. Thus, a proportionately larger reserve may be required for its financing or for possible future losses.

Order of Payment

319. In many instances, exempt cooperatives have outstanding on their records a series of unpaid patronage refunds arising from the operations of several prior years. These may be represented by mere book credits, by certificates of debt, or by any of the forms described in paragraphs 298-305. It is believed that the Bureau will not object to the retirement of such credits in an order different from their origin.

320. For example, assume that credits exist for savings from the years 1937, 1938, 1939, and 1940. An association normally would pay them off in serial order by years beginning with 1937. However, it probably is permissible to retire the 1940 items first, or to use any order deemed desirable. Retirement in the order of origin, being generally the fairest method, should be followed unless there is a seriously impelling reason to do otherwise.

Treatment of Certain Patrons

321. If a patron declines to become a member, or is ineligible for membership (as often happens where a nonproducer deals with an association in purchasing supplies), the portion of his allocated savings up to an amount equal to the value of the minimum capital share or fee necessary to qualify for membership, may be handled in one of the following ways:

A. For a capital stock cooperative, issue a special type of stock certificate, such as preferred shares stated to be nonvoting, nonparticipating, and nondividend bearing. Authority for issuance of such stock should exist in the association's legal structure.

B. For a capital stock or a nonstock cooperative, issue a certificate of debt, investment, or equity, or even a simple nonnegotiable note or bond. These preferably should be noninterest bearing and may be made payable only on dissolution, or earlier in the discretion of the directors.

C. Let the described portion of the patron's savings stand permanently to his credit simply as a book entry, without issuance of any written instrument. It is not certain that this particular procedure will be approved by the Bureau, but it stands a reasonable chance of being permitted. (See par. 393.)

In an unpublished ruling a few years ago, one cooperative was permitted to charge nonmember patrons three dollars each year to match an equivalent annual fee demanded from members.

322. In all of the foregoing methods, once a patron's allocated savings become equivalent to the minimum membership share or fee, he should

thenceforth be treated the same as a member in the payment or other disposition of any further savings apportioned to him.

Unaccepted Certificates

323. Where capital certificates are rejected by nonmembers who do not wish to become members, some managers simply hold the certificates in the office safe, with the association's financial statements indicating that the stock is actually outstanding. This practice is not recommended for it resembles subterfuge, if it is not actually that. It is a well known principle that patrons cannot be forced into membership. A better procedure in those cases is to cancel the certificates and to rely upon one of the procedures outlined in paragraphs 321-322.

Deferred Payment for Nonmembers

324. Some associations have extended the procedure outlined in paragraph 321, item C, so that a nonmember's share of savings continues to accumulate each year, resulting in credits far exceeding the amount of a minimum capital share, while savings of similar origin are paid in cash to members. This represents a discrimination, and most surely would be a cause for suspension of exemption eligibility.

325. Many cooperative managers and their advisers have been under the impression that this particular plan is within the permitted scope of the Bureau's regulations. That condition arose through a misinterpretation of the Treasury Department's ruling contained in Mimeograph No. 3886 of July 9, 1931 (C.B.X-2, 164). The portion of the ruling in question is quoted as follows:

"However, where a cooperative marketing association [it is believed there was no intention to exclude purchasing associations] has otherwise complied with the provisions of the statute respecting exemption, but defers the payment of patronage dividends to nonmembers, exemption will not be denied--

"1. Where the by-laws of the association provide that patronage dividends, by whatever name known, are payable to the members and nonmembers alike, and a general reserve is set up for the payment of patronage dividends to nonmembers.

"2. Where the by-laws provide for the payment of patronage dividends to members, but are silent as to the payment of patronage dividends to nonmembers, but a specific credit to the individual account of each nonmember is set up on the books of the association.

"3. Where the by-laws are silent as to the payment of patronage dividends to either members and/or nonmembers, but the evidence submitted shows that it has been the consistent practice of the association to make payment in cash or its equivalent of patronage dividends to members and nonmembers alike within a reasonable period after the expiration of the particular year involved.

"4. Where, under the circumstances stated in 1, 2, and 3, above, patronage dividends are not payable until the nonmember becomes a member of the association either through the payment of the required amount in cash or the accumulation of dividends in an amount equal to the purchase price of a share of stock or membership."

[Bracketed wording and underscoring added.]

326. The Bureau's intention is that subparagraphs Nos. 1, 2, and 3, should pertain only to the circumstances outlined in subparagraph No. 4. This brings about the effect that the latter paragraph is the only one which can be directly linked to the introductory sentence. Or to put it more clearly, the intention of the ruling is that the situations outlined in the first three subparagraphs apply only up to the amount of the minimum fee or capital share required for membership, as detailed in the fourth subparagraph. When that point is reached, the patron, in the absence of his refusal, and if eligible, usually becomes a member. Thenceforth his portion of the savings is subject to the same treatment as any other member. This version of the ruling has been carefully investigated and checked with Bureau personnel.

327. In summary, it should be stressed that savings credited to a nonmember above the value of a capital or membership share must be paid to him in the same manner and at the same time as counterpart credits are paid to members. Contrary treatment will furnish cause for revoking the letter of exemption.

Unpaid Memberships

328. Credits to a nonmember for his portion of savings should be continued indefinitely looking forward to the possibility of their equaling the value of a membership share. Such credits should remain on the books even after a person has withdrawn his patronage, has left the local section, or has died. Under those conditions the bylaws of some associations authorize a cash refund of the credits immediately, or whenever savings of similar time-origin are paid to members. (See pars. 338-339.) That practice, it is believed, is not objectionable to the Bureau.

329. As a general rule, a nonmember's savings credits which have not equalled the value of a membership share should not be appropriated (written off) but rather should be permitted to remain intact until the association's dissolution. Some of the State cooperative acts, however, authorize the appropriation of such credits after a specified period of time.

330. While the Bureau has permitted some cancelations of this kind in the past, it is believed that it would not be safe to rely upon such a precedent in the average case. If an association decides to hazard the effect of such a practice, it at least should not attempt to make the write-offs until a reasonable period has elapsed, say not less than 4 or 5 years. In all cases, at least the period of limitations set by State law should be observed.

331. Credits of this nature to patrons who cannot be located may be handled as outlined in paragraphs 336-337.

Nonmonetary Memberships

332. Some associations do not have any monetary requirement to qualify for membership, such as the purchase of a share of stock or the payment of an entrance fee, etc. Exempt cooperatives of that type are not permitted to withhold from nonmembers any savings derived from transactions with them over and above any counterpart withholdings from members.

Deductions for Financing

333. Other associations have no entrance requirement but secure funds for financing purposes through authorized pro rata deductions (often termed "retains") from the sales proceeds of members' products. These deductions sometimes have the nature of loans. In other instances they may be considered as capital contributions. Where the deduction system is in effect, the Bureau probably would have no objection if an exempt association makes like deductions in the case of nonmembers. It is believed this would hold good even though the deductions were not specifically or directly authorized by the nonmembers. Any eventual refund of such deductions must be made in the same manner and at the same time for both members and nonmembers. This fulfills the exemption statute's requirement for equal treatment.

Forfeiture of Credits

334. Where an exempt association follows the practice of appropriating or canceling either a portion or all of any credits standing in the name of a member or nonmember when he ceases to do business with the organization, there is a considerable possibility that the Bureau may hold this to represent unequal treatment. It could be argued that in one sense this practice is equitable since all patrons are treated alike when and if their patronage ceases. The possibility of considering the practice a discriminatory one seems increased when the appropriated credits vary in amount among individual patrons. The type of credits involved here include any accounts or notes payable, patronage refunds payable, interest in the capital reserves or in savings allocations of other description, capital stock or other capital shares owned by the patron, etc.

335. If the forfeiture is agreed upon in advance between the patron and the association by a specific contract, or in the case of a member through a bylaw provision, the Bureau may take this into consideration and it might furnish a justification for consent to the practice. Even though a contractual basis exists, however, any such forfeiture might be deemed inequitable by the Bureau when it exceeds in amount what could be regarded as reasonable liquidated damages to the association. (See reference to this subject in pars. 548-551.)

Unlocated Creditholders

336. Where patrons cannot be located at the last known address, their portion of the savings and, in fact, any other amounts owing to them ordinarily should remain credited indefinitely, or until dissolution. However, if preferred, the association may transfer (write off) such

credits into the income account after lapse of the period of limitations set by State law. It is desirable to preserve any proof of the effort to reach such patrons, for example, an envelope officialy returned by the Post Office Department.

337. Some States do not prescribe an applicable limitations period. In that case common law respecting the appropriation of declared capital stock dividends probably would be held to govern by analogy. If operations extend into several States, the procedures might have to coincide with the respective statutes.

Payments Upon Withdrawal

338. As mentioned in paragraph 328 savings credits or other equities belonging to a member or nonmember are often paid in cash upon, or within a stated period after, withdrawal of patronage. From a long-range viewpoint this might be thought to represent an inequitable procedure since the patrons so paid are thus relieved of any responsibility for absorbing future losses. It is believed that the Bureau would not offer any objection to this practice, however.

339. Conversely, the Bureau does not require that such payments be made upon withdrawal. Normally, credits of withdrawing patrons are paid only as and when credits of similar time-origin are paid to other patrons. Some State cooperative acts provide that, where the bylaws do not otherwise stipulate, a member's interest in an association must be appraised and paid to him or to his estate within a specified time after his withdrawal, resignation, or death.

Price Discrimination

340. It seems possible from at least one recorded case 38/ that tax authorities might look with some disfavor on the concurrent use of two or more methods of accounting for products received by an exempt marketing association. An objectionable price discrimination may be so involved where, for example, a marketing association pools the sales proceeds of some patrons, while making outright purchases from others.

341. Even if the nonpool patrons as a group receive, after savings are distributed, an average return for their products that is the same per unit and grade as paid to the pool patrons, discrimination possibly may be held to exist if some of the nonpool patrons receive less than others, or less than the pool price return. No published rulings exist to indicate that this type of situation is considered definitely as a discrimination.

342. An adjustment could be made, of course, to partly equalize the described inequality. Thus, savings from the nonpool transactions (or an amount taken out of pool proceeds) could be distributed so that none of the nonpool patrons receive less than the pooled average price. This would leave a group of the nonpool patrons which had secured a higher average.

38/ See Producers' Produce Co. v. Crooks, 2 F. Supp. 969 (1932).

If this group were composed of nonmembers their superior treatment might be held not to affect exemption. (See pars. 239-241.)

343. The foregoing comment applies to the handling of one variety of product. Where more than one variety is involved, the use of a different method of acquisition for each variety probably would not be considered discriminatory.

344. A definite discrimination would exist if an association used variable prices at one particular time for the same quantity and the same quality when acquiring products or selling supplies, if the price variations were not equalized later through offsetting variations in the rate of patronage refunds. (See contrast in pars. 349-351.)

345. It is believed that the Bureau is not concerned whether equality in pricing or in paying returns (which may involve justified variations in handling charges as explained in pars. 251 and 354-359) is achieved by an exempt organization at the time of actual transaction with patrons, or by later equalization through the use of variable patronage refunds, as described, which are allocated or paid at the end of the accounting period, not later, of course, than the close of the current fiscal year.

346. The foregoing observation applies only to the type of cooperative which takes title to the products or supplies handled, and to organizations which operate as agents but which do not pool sales proceeds or operating expenses. It is not intended to indicate that day-to-day price variations, such as those described in paragraphs 349-351, must be equalized at the end of the fiscal year. It refers, rather, to price differences such as mentioned in paragraph 344, which palpably would represent a discrimination if not equalized later. Associations operating on a pooling basis, do not come within these remarks, as the pools normally would represent an equitable distribution of net sales proceeds.

Purchases from Other Cooperatives

347. Marketing associations often make emergency purchases (see pars. 114-123) from another cooperative. The selling organization may not be interested in taking any chances on an uncertain price resulting from pool participation and, therefore, insists upon a flat price arrangement with no expectation of further payments from allocation of the net savings.

348. Depending on the comparative price involved, this procedure conceivably may be held to be discriminatory. Whether the emergency nature of the transaction will serve to mitigate its effect on exemption is uncertain.

Other Price Differences

349. Not all price differences are discriminatory, of course. It is felt that the use of more than one pooling period during a year by a marketing association, resulting in different returns per unit for the same kind and grade of product, would not be regarded by the Bureau as a form of price discrimination. This assumes that the patrons of all pools receive their pro rata share of the year's net savings.

350. Furthermore, a marketing association which operates on a so-called purchase-and-sale basis, or a purchasing association dealing with patrons at prices which vary from time to time, is not thereby regarded as practicing price discrimination. Such organizations should make every effort, however, to set prices, so far as may be feasible, in such a way as to yield a uniform gross margin throughout a particular accounting year. (See par. 258.)

351. Some purchasing organizations, in recognition of this point, keep their accounts so as to reflect the actual gross margin on each patron's transactions, thus producing a clearly equitable base for the allocation of savings. Such a procedure is impractical, however, for most types of purchase-and-sale marketing associations.

Voluntary Discrimination

352. Some cooperative associations have made provision in their bylaws or other legal papers to pay higher prices or higher returns, for an equal grade of produce, to one group of members as compared with another group. Usually the charter members are favored in that manner. Despite the voluntary nature of such an arrangement the Bureau probably would consider it a nonobservance of the exemption requirement for equal treatment.

353. It is felt there is no essential difference between voluntary and involuntary discrimination. This follows the theory already expressed in paragraphs 238 and 241 that any savings (gain) derived from one group and transferred to another probably would be held to constitute a taxable distribution, excepting, of course, dividends on capital shares. (But see par 316B.)

Quantity Premiums and Discounts

354. Prices or returns per unit are sometimes arranged to vary according to the volume of products received from, or sold to, each patron. The same result often is accomplished by varying the rate of patronage refunds according to the volume of transactions.

355. It is believed possible that an exempt cooperative will be permitted by the Bureau to give price discounts according to the volume of supplies sold to patrons. It seems clear that large-volume supply purchases, compared with smaller ones, could be handled and possibly could be acquired by an association at a lesser cost per unit. (See pars. 242-245.)

356. In marketing operations, while large amounts of produce probably can be processed and sold at a unit cost less than for small volumes, it does not follow necessarily that the actual sales price per unit is enhanced by a larger volume. Obviously, large volumes could result in either higher or lower prices, according to market conditions.

357. Where an exempt marketing association desires to pay variable unit prices or returns according to the quantity of products furnished by producers, it is believed that the Bureau will not consider this a violation

of equality provided the variations are applied equally to both members and nonmembers and the returns are based upon clearly justifiable differences in handling costs. (See par. 251.)

358. Unless competitive conditions force the issue, it appears best for both marketing and purchasing cooperatives to avoid the use of such price differentials. There is some analogy here to the one-man-one-vote principle. Small producers thus are given an equal voice with those who operate on a large scale. The fairness of this tenet is debatable, of course. Certainly there are many fine cooperatives that have not accepted the idea.

359. While the one-vote feature is not mandatory for tax exemption purposes, it is one of the alternate requirements under the Capper-Volstead Act through which farmers' cooperatives may secure immunity from the antitrust laws insofar as their normal operations are concerned. Thus Congress has put this plan forward as a desirable, although not a necessary, feature of mutual operation.

Necessary Expenses Defined

360. By referring to paragraph 227, it will be observed that the statute uses the terms "necessary marketing expenses" and "necessary expenses," but provides no definitions thereof. The Bureau's regulations and published rulings do not indicate directly any particular limitation in this respect, except for depreciation charges which are restricted to a reasonable annual rate, as outlined in paragraph 439A.

361. Any type of expense essential to the marketing or purchasing operations of the business undoubtedly would not be questioned (see par. 90). While the Income Tax Regulations for corporations designate certain expenses as unallowable for purposes of calculating taxable income, it is felt the Bureau will not necessarily follow those regulations where tax-exempt associations are concerned.

362. In general, out-of-pocket expenditures, either paid or accrued, when related to the permitted functions of an exempt farmers' association probably will not come under any question. Expenses, the amount of which is theoretically computed, such as those represented by valuation reserves, may be scrutinized more closely. Such reserves, according to the exemption statute, must be of a necessary character, and therefore come directly under the Bureau's observation as explained in paragraph 416 et seq.

363. The Commissioner undoubtedly is responsible for determining what constitutes "necessary expenses." Thus, the Bureau conceivably could object to exorbitantly high salaries, and excessive amounts of other controllable expenses.

Fertile Dairy Decisions

364. The exemption statute specifically permits an exempt farm cooperative to withhold a limited amount of savings ("earnings") in the form of a capital reserve for any proved necessary purpose, which is fully discussed under Requirement No. 4, beginning on page 93. The Treasury

Department for years has permitted such a reserve (or "surplus") to be considered and handled as if owned by the association itself, for its own account, without definitely recognizing the equities of past patrons in the reserve, arising from their patronage share of annual savings.

365. Thus, in the absence of express provision to the contrary, such reserves under the laws of most States, would revert upon dissolution to the association's then existing stockholders or members. Such a course normally would result in the exclusion of past patrons from participation in the distribution of net assets. In the following language quoted from page 239 of Income Tax Regulations 103, the Bureau's position in the past is clearly indicated (for full text, see pages 156-158 herein):

"(c) In order to be exempt . . . an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in (a)."

366. When these regulations are reissued, the above-quoted portion probably will be revised to coincide with a much stricter attitude resulting from recent decisions by the Federal Courts in the case of the Fertile Cooperative Dairy Association v. Huston, Collector of Internal Revenue for the District of Iowa.39/ Those decisions have been published in the Bureau's Cumulative Bulletin (C.B. 1941-2, 180) which according to established custom indicates the Commissioner has accepted the principles involved. On good authority it is understood the Bureau intends to use these principles in determining exemption eligibility for farmers' cooperatives in similar future circumstances.

Legal and Accounting Effects

367. When that association made application to the Commissioner of Internal Revenue for a tax-exempt status, it was denied for several reasons. The tax then was paid and a suit for refund thereof was entered before the United States District Court. The latter denied exemption but did so on new grounds entirely different from those advanced by the Commissioner. The Court held the association ineligible for exemption because its legal structure did not provide that nonmember patrons would have an equitable interest in the net assets upon eventual dissolution, and furthermore because the association's operating and accounting procedures did not attempt to effectuate that end. In one sense this is a somewhat academic viewpoint because most associations at dissolution usually have no reserves. However, a practical application does exist whenever any assets represented in the reserves are distributed.

368. On appeal, this finding was affirmed by the United States Circuit Court of Appeals on April 26, 1941 (119 F. 2d 274). These decisions, as interpreted verbally by officials of the Bureau, mean that all annual operating savings (after provision for limited dividends, if any, on capital shares) must be allocated to the credit of each patron, including

39/ 33 F. Supp. 712. Aff. 119 F. 2d 274.

nonmembers, in proportion to patronage. A further practical effect is that such allocations actually must be entered in a suitable permanent record. (This subject is discussed at length in pars. 467 et seq.)

369. The entry of such allocations does not mean that the savings must be paid out before dissolution. In the discretion of the association, part or all of the annual savings so allocated may be withheld as a capital reserve subject to reduction by future operating losses and payable, if desired, only on dissolution. (The purpose and amount of the reserve, however, must be within the scope of Requirement No. 4, as outlined beginning on page 93.) It follows that if all annual savings are so allocated to each patron, the association's capital reserves will be always in a similar allocated state.

370. In addition to the entry of allocations, the legal papers of exempt associations (articles of incorporation, bylaws, membership or marketing agreements) must contain a provision binding the association to make savings allocations in the prescribed manner at least once yearly at, or shortly after, the close of its accounting period. Such provision should indicate clearly that the allocations become the property of each patron. It appears desirable to indicate also that such allocations are payable only upon dissolution (or earlier, in the discretion of the directors) and are subject to reduction at any time without notice by future operating losses which may be encountered by the association. (But see par. 372.)

371. In this way an allocated reserve, while in a sense a capital equity, does not lose its essential nature as a reserve. In this respect it differs from a deferred liability for patronage refunds declared payable at a future date, or payable only on dissolution, since such refunds ordinarily are not subject to reduction by future losses except in a different sense as a result of the complete extinguishment of any formal capital which may exist. (See also pars. 301, 421-422, and 636-637.)

372. The foregoing paragraph expresses the views of the writers on the status of an allocated reserve. It is pointed out, however, that there are some who believe the Fertile Dairy decisions may be interpreted to mean that an allocated capital reserve must become the absolute property of those to whom it is credited, without being subject to reduction for losses, except, of course, the losses that may exist at the time of dissolution.

Further Legal Effects

373. As a result of the Fertile Dairy decisions, it appears that capital stock or other capital shares may not have any right to participate in an exempt association's operating savings, upon or before dissolution, beyond declared or cumulative capital dividends. Some associations might encounter difficulty in legally accomplishing that result if the present shareholders have rights under specific provisions in the capital certificates, the bylaws, and possibly in some of the State statutes.

374. Certain types of capital stock are issued with a preference in the distribution of residual assets upon dissolution. Such a preference may include a claim upon assets in excess of the par value of the preferred shares, plus accrued dividends. Apparently under the Fertile Dairy decisions it is necessary for cooperatives to nullify any such gainful participation in any savings that originate from direct transactions with patrons.

375. This probably could be accomplished by declaring the allocated operating savings or reserves as specific capital equities or even as payables without due date. It could be stated that such equities or payables in the event of dissolution rank after general creditors and after payment in par of the preferred shares, but are subject to automatic reduction by interim operating losses. (See pars. 510-512. See also pars. 636-637, and for capital gains see pars. 380-389.)

Written Instruments

376. The Fertile Dairy decisions do not obligate an exempt association to issue certificates or other written instruments to evidence the allocated equities in the reserve. Apparently such issuance would not have any particular effect on the character or rank of the reserve. Nevertheless, in other phases of Federal taxation as, for example, in connection with the method of calculating equity capital increases for determining excess-profits taxes, the Treasury Department differentiates between equity capital and borrowed capital partly as to whether or not it is represented by an instrument in writing. On the other hand, section 19.22 (a)-17 of the Bureau's Regulations 103 specifically states that contributions to capital by shareholders are not considered taxable income even though such contributions may not be evidenced by the issuance of certificated shares. (See also pars. 299 and 522-528.)

Retroactive and Future Application

377. The question arises whether the Fertile Dairy decisions will be considered by the Bureau as applicable only to capital reserves arising after April 26, 1941, the date of the affirming decision, or to all existing capital reserves. Since the past and present regulations of the Bureau give the impression that reserved savings need not be allocated to each patron, it is likely the Commissioner of Internal Revenue will not be inclined to insist upon a retroactive allocation.

378. Nevertheless, since the Fertile Dairy decisions themselves were applicable directly to the Association's current reserves, it appears that the safest course for cooperatives to pursue is to immediately:

A. Make the necessary changes in the association's legal papers (if not already adequate) so as to give the reserveholders a valid interest in their shares, subject only to reduction by future operating losses.

   If this procedure cannot legally be applied to the existing reserves, then at least it should be followed for any future additions. If voting majorities or other reasons make the latter course impractical, the association is believed to be on unsafe ground. It is still possible, however, that its right to exemption may not be disturbed by the Bureau, especially if the following procedure is carefully and conscientiously carried out.

B. Allocate the present capital reserves by year of origin on a patronage basis to all patrons of those years, doing likewise for all future additions to such reserves. (The term "capital reserve" is intended to exclude all reserves which are created by charging expenses, such as reserves for depreciation, bad debts, etc. Reserves of that nature do not require allocation.)

   Where associations are unable to make retroactive allocations, because of the loss of records or through other unavoidable reasons, it seems quite desirable that the unallocated reserves be kept entirely separate from future allocated accumulations and be used first to absorb any future operating losses.

379. While apparently the Courts were concerned primarily with the protection of nonmembers' equities, it is clear that the principle involved in their decisions applies as well to members and to former members. In all likelihood, therefore, the Bureau will require that reserved operating savings be allocated by exempt associations which deal only with members. (See pars. 469-472.)

Extraneous Income, Capital Gains, etc.

380. As mentioned in paragraphs 228 and 235, it is felt that the exemption statute requires equality for all patrons, whether members or nonmembers, only so far as direct transactions with them are concerned in the main operating functions. This view apparently is supported in the following language taken from the Court's decision of April 26, 1941, in the Fertile Dairy case (see pars. 364 et seq.)

> "If part of the proceeds of nonmembers' products is to be used to create or maintain a surplus.....without allowing them a proportionate distributive interest in the permanent value contributed by such surplus accumulations.....it must be held that the association to that extent is being operated for profit to its members, as against nonmember patrons, and that it is not exempt from taxation." [Underscoring added.]

381. It appears from the foregoing that the Court's main concern was to protect the interests of nonmembers in any "surplus" (or reserves) which arose from "the proceeds of nonmembers' products." It is felt this leaves open the possibility of eliminating nonmembers from the allocation or distribution of extraneous income or gains, or of reserves arising therefrom. Such a course, it is believed, would not violate the exemption requirement for equal treatment.

382. The term "extraneous income," as here used, is defined and discussed in paragraphs 141-148. In general, it includes any income or gain arising from sources other than patronage transactions in marketing, purchasing, or related functions. In this sense, for example, the proceeds of an insurance policy which had been maintained by an association on the life of its manager, are classed as a nonoperating or extraneous gain. The amount of premium paid by the association throughout the policy term probably should be separated from the proceeds and credited to current operations. It also could be allocated or refunded to the past patrons who actually contributed to the expense.

383. Where the described types of gain are relatively small in amount, the practical procedure is to absorb them into the current pools of an association operating on a pooling basis. Other associations could combine such income with the year's operating savings for distribution to all ordinary patrons on a patronage basis, ignoring the actual source (payers) of such income. (See par. 142.)

384. On the other hand, if the amount of nonoperating or extraneous income is significantly large, it probably is desirable to distribute or allocate it in a manner legally compatible with the procedure which would be followed if the association were then about to dissolve. At common law, unless an association's legal papers or the State law stipulates otherwise, all assets, after payment of creditors, are distributable upon dissolution to the then existing members in proportion to their membership rights or shareholdings.

385. As a result of the Fertile Dairy decisions, the manner of distribution described in the preceding paragraph apparently is not now permitted for a tax-exempt cooperative, as already explained, so far as reserves that arise from operating savings are concerned. (See pars. 368 et seq.) It is believed that those decisions do not inhibit an exempt farmers' cooperative association from distributing nonoperating gains in any manner authorized by its legal structure. This would include distribution to members only, as above described; to member and nonmember patrons of a particular year; to member and nonmember shareholders; or to such shareholders combined with the holders of patronage credits, etc.

386. These generalizations must be modified to fit specific situations. For instance, the described income, if declared as a distribution to members or shareholders, is undoubtedly a dividend on capital. Hence, exemption eligibility would be destroyed in a particular year if such distribution exceeds an 8 percent rate or the State legal

interest rate, whichever is greater. (See rate discussion in pars. 516-531.) The Bureau might permit the crediting of the extraneous gain to a special reserve account such as "shareholders' reserve," "capital-holders' reserve," or "stockholders' reserve," as the case may be. This would be somewhat like the capital surplus of a commercial corporation. The reserve then could be declared and distributed as a dividend in yearly amounts which do not exceed the permitted annual rate. It, of course, might be desirable to hold the reserve intact for the absorption of possible future extraneous or capital losses. (See pars. 510-512 regarding extraneous gains on dissolution.)

387. When an operating loss occurs in a particular year during which an extraneous or capital gain is realized, it seems practical to use part or all of the latter gain to reduce or absorb the loss. Where adequate reserves exist, the operating loss normally would be charged against them, thus permitting a full allocation or distribution of the extraneous income. The permissibility of such procedures depends, of course, upon the association's bylaw or other legal foundation.

388. If depreciable property is sold at a gain and such gain is considerable, it might be desirable to determine whether a part or all thereof is the result of excessive depreciation. The amount of estimated overdepreciation represented in the selling gain may be thought to belong to the present and past patrons from whose proceeds the excess depreciation was deducted. In most cases, it probably is not feasible to ascertain the amount so derived from each individual patron.

389. As a compromise solution, therefore, it seems logical to divide the amount of gain which is attributable to overdepreciation among all those having patronage savings credits at the close of the fiscal year in which the gain occurred. The amount of gain not attributable to overdepreciation may be allocated or distributed to the holders of capital shares as mentioned in paragraphs 384-385.

Extraneous Losses or Charges

390. For the purpose of this discussion, an "extraneous charge or loss" is defined as one sustained through the sale or other disposal of any asset, not including, of course, operating inventories. It also includes any regular or extraordinary charge or loss that does not arise from patronage transactions in the marketing, purchasing or related operating functions.

391. Such a loss, it is believed, may be accounted for and allocated by an exempt cooperative in a manner somewhat counterpart to that described for an extraneous gain. In the absence of an express agreement with them, any nonmembers who are patrons in a particular year have no legal responsibility for the absorption or sharing of either an operating or an extraneous loss sustained by an association in that year. However, if a patronage savings credit or a credit of any description exists on the association's books to a nonmember, there probably would be no objection on the part of the Bureau if the association chose

to charge thereto the nonmember's patronage share of an operating loss. (See pars. 394 et seq.)

392. On the other hand, a nonoperating or extraneous loss theoretically should be borne entirely by members. This would parallel the treatment of a similar gain. It is believed there would be no objection from the standpoint of exemption if an extraneous loss were combined with operations so as to reduce the net savings, if any, that are available in a particular year for distribution or allocation to both members and nonmembers on a patronage basis. Any advantage to members resulting from such an accounting is more than offset by the fact that members of the average association must shoulder the burden of any net losses, whether of operating or nonoperating origin. (See par. 246.)

393. The following quotation is appropriate here:40/

"Nonmember business is carried on to some extent by many associations with the definite purpose of extending the cooperative service as widely as possible and at the same time as a means of encouraging increased membership, but so long as one deals with the association and does not actually become a member, some reasonable consideration might well be exacted for the hazard assumed by the member which the nonmember escapes."

Annual Operating Losses

394. Since the allocation of capital reserves to all patrons is now a requirement following the Fertile Dairy decisions, it seems desirable to comment on the accounting methods which hereafter will be involved in the handling of annual operating losses. As explained in paragraph 371, the apportionment to patrons of their respective equities does not essentially change the nature of a capital reserve and, therefore, it is available to absorb operating losses.

395. Business history shows that upon dissolution most associations are in unsound financial condition and therefore rarely would be found to have any capital reserves. Thus, the use of an equitable method of allocating the additions to such reserves has only a limited value unless a parallel method is followed in equitably reducing the reserve when and as losses occur. This observation, of course, does not apply where no future losses are encountered. In that case, the capital reserves would be distributed in accordance with the patronage allocations required by the Fertile Dairy decisions.

Specific Methods of Allocating Losses

396. If consistent with the provisions of an association's legal structure, any of the following suggested methods may be used for

40/ Evans, Frank, and Stokdyk, E. A. The Law of Agricultural Cooperative Marketing. 648 pp. Rochester, Lawyers Co-operative Publishing Co., 1937. See p. 255 therein.

handling an operating loss, and it is believed all of them are acceptable for use by a tax-exempt cooperative:

A. Apportion the year's operating loss to the individual patrons of that year on a patronage basis in the same manner as savings are allocated. The resulting allocated debits then are applied against any credits standing in the name of each such patron. In addition to previous capital reserve allocations, such credits may consist of any accounts payable, or any capital equities.

Allocated debits not so absorbed are then grouped and the total thereof is redistributed against all the holders of reserve credits in proportion to their holdings. If the reserves are not sufficient to accomplish this in full, any remaining balance of the loss then is carried forward as a deficit account to be treated as in method D, below.

B. If the reserves have not been allocated to past patrons 41/ an attempt should be made to do so. If this is found impossible, for example because of lost records, then the year's loss may be charged against the reserve without allocation to patrons.

As an alternative, the loss could be allocated to the current year's patrons and such allocated debits then could be carried forward in the nature of contingent receivables in the expectation of offsetting them against future credits earned by the patrons concerned.

If such future credits do not materialize, the allocated debits finally may be written off in the year when they are determined to be actually uncollectible. The resulting charge goes into operating expenses and thus is made against the patrons of the charge-off year, just as in the case of an ordinary bad debt.

C. Follow method A, except that the unabsorbed allocated debits are carried forward as contingent receivables and treated as described in method B.

If finally written off as uncollectible, the resulting charge could be handled as outlined in method B, or by spreading it against the credits of any existing reserveholders, in proportion to their holdings.

D. Follow method A, except that the unabsorbed allocated debits are grouped in a deficit account, losing their allocated nature, and are held for absorption out of future savings, on which allocation is also eliminated up to the amount of loss absorbed.

41/ Allocation of all reserves arising after April 26, 1941, is now a requirement; this also may be required for reserves arising before that date. (See pars. 377-379 herein.)

E. Make no patronage allocation of the year's loss but carry it forward as a deficit account until some logical absorption time, such as when a cash distribution of savings or capital reserve credits is contemplated. Then, before such distribution, eliminate the deficit account by apportioning it to all the existing holders of reserve credits, pro rata to their holdings. This method spreads the loss over the patrons of several years.

Other Methods

397. No doubt, some of the foregoing methods represent a more equitable treatment than others. Opinions, of course, will vary as to just what constitutes equity in a matter of this kind. It is entirely possible, also, that other and perhaps more desirable plans could be worked out. Those suggested are thought to be fair and reasonable. It is hoped their presentation will stimulate some discussion on the subject.

398. If the association's legal structure and the State laws permit, it is possible, also, to charge operating losses or capital losses directly to capital shares. If the owners of such shares hold certificates therefor, the described charge could be handled, upon authorization from the directors, by directly transferring the loss on the association's books to the capital share account. The balance sheet then should show this transfer in a manner somewhat like the following:

Capital stock outstanding.....	$20,000
Less: Authorized reduction for loss of 1940 season.....	2,000
Reduced stated value of capital stock outstanding.....	$18,000

399. If proper authorization exists, a loss may be divided between the capital shares and the allocated reserve credits arising from patronage savings.

400. Whether a nonmember's or even a member's present share of savings credited to him as a reserve is usable legally to absorb his share of a loss in a later year of his patronage, depends upon the association's legal structure. This is likewise true as to the absorption of a future loss in a year when he did not patronize the association. In general, if an association has proper authority to set aside reserves it is likely this would be held to imply an authority to use such reserves in any manner chosen by its directors.

401. Where patronage refunds are declared as a definite payable, the patrons so credited usually have a legal status equal in rank to that of other general creditors and therefore the amount of such refunds ordinarily cannot be reduced by the application of future losses. This excepts, of course, the situation which may prevail upon dissolution of an association where refundholders or other creditors may not be paid in full because sufficient assets are not available.

Impaired Capital

402. Where an impairment of formal or stated capital (such as capital stock) exists, it seems possible that the Bureau would permit an exempt

cooperative to suspend the allocation of savings to patrons until such time as the impairment is absorbed (eliminated). Many States, apparently for the protection of creditors, prohibit the declaration and payment of dividends on capital stock while such an impairment exists. By analogy, this restriction might be held to apply in the case of patronage refunds. It seems likely that the mere act of allocating a cooperative's savings, or their conversion to capital shares, would not come under this prohibition. (See also pars. 656-657.)

Adjustments Applicable to Prior Years

403. It often happens that an item of income or expense is found to be applicable to the operations of a previous year. In commercial accounting such an item is referred to usually as a "surplus adjustment." When the amount concerned is relatively small, an exempt cooperative association operating on a pooling basis could combine it with the current pools. Nonpool associations, if they desired, could place such an item in their current-year operations for distribution or allocation to the patrons of that year on a patronage basis.

404. When, however, the described income or expense item is substantially large in amount, it is desirable generally to exclude it from the operations of the current year. In such an event, it would be entered as an adjustment so as to either increase or decrease each patron's allocated share of the particular prior year's savings or losses, as the case might be.

Business for the United States

405. Requirement No. 2, calling for equal treatment among all patrons, need not be followed regarding transactions with agencies of the Federal Government. (For detailed information on this subject, refer to pars. 203-226. Refer also to pars. 411 and 488.)

Requirement No. 3

Business with Nonmembers Must Not Exceed that Done with Members

Division of Business

406. Under an express provision in the exemption statute, the amount of business with nonmembers must not exceed the amount done with members. For convenient reference, the statutory provision is here quoted:

> "Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members..."

407. The division of business, therefore, between members and nonmembers must be based on the dollar amount of transactions, rather than on the unit volume of product, or merely on the number of patrons in the two classifications. This is different from the methods permitted for the calculation of patronage refunds (see pars. 268-273).

408. For the purpose here concerned the statute is construed to permit any of the following dollar-amount measurements of business volume, according to conversations with Bureau officials:

A. Purchase value of products purchased from patrons.
B. Net proceeds value of products marketed for patrons.
C. Value of marketing fees or commissions, packing or other service charges assessed to patrons.
D. Value of supplies and equipment purchased for and turned over to patrons, at purchase cost to association or at price billed to patrons.

Note: Savings may be allocated on the basis of gross margins less allocated expenses (see pars. 269-273) but business volume cannot be so measured since margins not only vary according to the time of purchase but actually may be nonexistent.

Payers of Miscellaneous Income

409. Whether miscellaneous income and the payers thereof should be included in the calculation of member and nonmember business depends on the character of the income. (This is treated in detail in pars. 138-143.)

Dual-Purpose Cooperatives

410. Where an association is engaged in marketing as well as supply operations, its business with nonmembers in each of these two departments, figured separately, must not exceed the business done with members. Thus, a marketing organization which operates a comparatively small side-line supply business as a convenience to patrons, becomes ineligible for exemption if the side-line department alone transacts business greater in value with nonmembers than with members. (See further restriction outlined in pars. 476-478.) This does not apply to individual subdepartments.

The business of each such unit, however, must be placed under either the marketing or the supply department, to whichever it properly relates.

Business for the United States

411. Business done for or with the United States or any of its agencies, as described in paragraphs 203-226, may be placed in an entirely separate classification and considered as neither member nor nonmember business for the purpose of determining exemption eligibility. How this should be done is shown in the following illustration (see also par. 488):

Classifications of Business	Business volume	Percent
Members	$ 55,000	55
Nonmembers	45,000	45
Total of member and nonmember business	$100,000	100
United States and its agencies	20,000	
Total business	$120,000	

Interlocking Business

412. Some central associations have local cooperatives for their members. If a member of the local deals directly with the central, is this to be considered as membership business on the central's records? No published rulings have appeared on this point. It is probable, however, that the Bureau would class this as nonmember business despite the affinity between the two cooperatives. (See definition of a member in pars. 179-184.)

413. Membership in some local cooperatives is open only to those who are members of an affiliated central association. Despite this arrangement, it is felt that members of the central will not be considered by the Bureau as members of the local unless they have a voting right in the latter's management. Some local cooperatives meet this requirement by providing an automatic voting right within a particular year to any of their patrons of that year who are members of the central association. If, by agreement between the local association and the central association (or between any two cooperatives) the members of the local deliver their products directly to the central association, in the local's name, there seems no reason why this should not be classed on the central's records as membership business done with the local.

414. Patronage refund on such business would be returned to the local. The latter then could handle the refund as an asset for distribution or allocation to its particular members from whose transactions the refund originated. It is thought probable that the Bureau would not require such a refund to be distributed or allocated to all of the local's members or patrons including those who did not deal with the central association and who, therefore, had no part in the origin of the refund.

Cross-Index

415. Some definitions and other data pertinent to Requirement No. 3 may be found at other locations in this report, as follows:

Requirement No. 4

Financial Reserves Must Have a Necessary Purpose and Must Be Reasonable in Amount

Reserves Defined

416. Section 101(12) of the exemption statute respecting farmers' cooperatives carries the following provision:

> "...nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose."

417. As therein used, the term "reserve" is intended to embrace not only all types of financial reserves, such as "surplus" or capital reserves and operating or valuation reserves, but, as well, all types of "surplus," however named. On the other hand, the term "reserve" does not apply to capital stock or to other capital shares, nor does it refer to certificates of indebtedness or other types of liabilities owing to patrons or others.

Improved Terminology

418. The extreme broadness necessitated in the foregoing definition illustrates the need for improvement and greater uniformity in the accounting and financial terms used by farmers' cooperatives. As it stands today, cooperatives for the most part are merely borrowing the nomenclature in use by commercial business concerns. Quite often this practice obscures the true nature of cooperative operations.

419. Is there any justification, for instance, in the use of the words "profit," "gain," or even "net income" by an association which is operating on a cooperative or mutual basis? Would it not be better to use the term "patrons' savings," "undistributed proceeds," "amount to be refunded," "amount to be reserved," or some other appropriate language? (See also pars. 261-263.)

Why Call it "Surplus"?

420. Cooperatives, in particular, should avoid using the term "surplus"42/ since it connotes to most people a commercial operation for profit. A corporate surplus is usually thought of as available to capital holders, not to patrons. Surplus of that type is contrary to cooperative principles and likewise to the rules of exemption especially when it originates from operating savings. (See pars. 510-512.) Therefore, a different term is desirable for the withholdings which are permitted. Moreover, since the exemption statute itself permits reserves by name, but makes no mention at all of surplus, it seems desirable and wise to match the exact language of the lawmakers.

42/ There is a current movement among professional accountants to abandon the term "surplus" in the financial statements of commercial corporations. See Report of the Subcommittee on Surplus of the Committee on Accounting Procedure, American Institute of Accountants. Journal of Accountancy, May 1942. See p. 451 therein.

421. A true capital reserve is not actually the same thing as a corporate surplus. Cooperatives by their very nature should have no valid surplus, but, on the other hand, may have reserves for general or specific purposes. The amount needed for particular purposes may be either actual or estimated. Aside from any requirement for tax exemption, it appears to be a sound cooperative principle that no amount should be withheld from distribution to patrons without some reasonable justification for its withholding. (In past years many farmers' cooperatives were "afflicted" with quite a different problem, namely, the lack of adequate reserves or other capitalization! Some, unfortunately, still are.)

422. Furthermore, such withholdings should have some logical calculation as a basis. When savings are so reserved and are then allocated to each patron on a patronage basis, as outlined previously, they lose all semblance of a surplus and become instead virtual, if not actual, capital equities. (See pars. 371, 450, and 451.)

What Are Necessary Reserves?

423. On page 238 of the Bureau's Regulations 103 the following comment appears:

> "...or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption."

424. Mimeograph 3886 (C.B. X-2, 168) of July 9, 1931, issued by the Acting Commissioner of Internal Revenue, has the following to say concerning reserves:

> "The phrase, 'reasonable reserve for any necessary purpose,' has been construed to include reserves accumulated or maintained to meet capital expenditures of associations. Where such an association has investments in building, machinery and other property which, due to depreciation through use in the operations of the association, eventually reach a point where their usefulness is exhausted, such depreciation in a given year is properly chargeable against the patrons of the association as a part of the 'necessary marketing expenses' of that year, and a reserve for the replacement of such property set up ratably over the period of the useful life of the property will be recognized as a necessary purpose within the meaning of the statute and the Departmental regulations."

425. It is assumed that the latter part of the foregoing quotation refers to an ordinary depreciation reserve related to physical property, although such a reserve technically may not actually function, as the regulations state, "for the replacement of such property." A depreciation reserve measures the diminution in the book value of an asset, but does not always or necessarily provide funds or other assets for the replacement of property. (See comment on depreciation rates in par. 439A.)

Other Essential Reserves

426. The reserves described in paragraphs 423-425 are the only ones mentioned in official publications. A number of other types of reserves nevertheless are believed to come well within the necessary class as, for example, a reserve (better called an allowance) for uncollectible receivables, a reserve for possible loss from a pending lawsuit or other specifically known contingency, a reserve for educational expenditures whose function is mainly to equalize educational expense by years, a reserve for a cash bond which the association may be required to post with governmental bodies as a requisite for the conduct of its operations, and other reserves for specific and essential purposes, including a reasonable general reserve to provide for possible future loss years and a reserve for working capital or for the financing or capitalizing of any necessary assets. (See discussion of reserve types in pars. 636-637.)

427. The entering of estimated accruals of expenses is, of course, a permitted accounting procedure. While some accountants class these as operating reserves, they are not so considered in this report. At any rate, their nature puts them in the "necessary" class.

Special Reserves

428. For an association which carries substantial quantities of owned inventory, especially where the products are being aged or the turnover is slow for other reasons, a reserve for post-war decline in inventory values is likely to be considered by the Bureau as of a necessary character. The calculation, accumulation, and other handling of such a reserve is a rather involved subject which will be covered in forthcoming publications, along with optional methods of pricing inventories.

429. It is uncertain whether a reserve for fire loss or for self-insurance would be considered by the Bureau as of a necessary character. Such reserves may not be used by nonexempt corporations in computing taxable income on the theory that the contingency is too remote. Nevertheless, premiums paid for fire insurance policies are ordinarily considered a legitimate, deductible, business expense for taxable corporations.

Reserves Required by Law

430. Many of the State laws, particularly the cooperative acts, require farmers' associations to set aside annually a certain percentage of their net savings into a reserve until the latter reaches a specified amount, usually a fixed proportion of formal capital. As outlined in paragraph 416, such a reserve is expressly permitted by the statute. Although not restricted in amount, it must be allocated annually to all patrons in proportion to patronage, as explained in paragraph 378B.

431. The Bureau's Mimeograph 3886 (C.B. X-2, 168) of July 9, 1931, makes the following comment on State reserves:

> "...it must be a reserve required by a State law; a reserve permitted but not required does not meet this test of exemption."

432. It is possible, of course, that a reserve merely permitted by State law may have a necessary purpose compatible with the exemption requirements, despite the fact that it is not actually required by the State statute.

433. A reserve for educational expenditures (sometimes called an "educational fund reserve"), as mentioned or authorized in some of the State cooperative acts, is usually set up by a charge to educational expense. It therefore represents an operating reserve designed merely to equalize such expense over the yearly accounting periods. This and other types of operating reserves need not be allocated to individual patrons (see par. 378B).

434. It should be emphasized, however, that an educational reserve must be confined strictly to its primary function and not be made a "dumping ground" for miscellaneous charges and credits. In particular, it should not be permitted to constantly accumulate and increase in amount. Rather, the amount actually set up therein at the end of a particular fiscal year should be disbursed shortly thereafter, certainly within a year's time.

435. If such a reserve is constantly increasing, it may become in effect a capital reserve subject to other requirements, including the necessity for apportioning it among patrons. Should the Bureau deem it a capital reserve, its amount then would have to be kept within reasonable limits as outlined in paragraphs 438-451.

Amount of Reserves

436. The exemption statute permits "a reasonable reserve for any necessary purpose." The word "reasonable" has been construed as applicable to the amount of such a reserve. Neither the statute nor the Bureau's Regulations define a reasonable amount. It has been the Commissioner's practice, as administrator of the law, to make such determinations only in individual cases.

437. He has not attempted in any written decisions to lay down general rules on the point. Generalities are of limited use where the factors concerned and their interrelations are so variable. The composition, amount, and functional character of each asset and each liability are some of the factors that must be carefully analyzed in each individual case.

What Is a Reasonable Amount?

438. In times of high prices, like the present, reserves in the average case should be augmented. More funds are needed to finance inventories, accounts receivable and other current assets. When losses from bad debts occur, they will be comparatively greater. If and when prices recede, losses on owned inventories may be much greater than when low prices prevail.

439. As indicated, the Commissioner of Internal Revenue is free to exercise his judgment in specific circumstances. Generally, it is felt

he probably will be guided by considerations somewhat like the following in his appraisal of whether a particular reserve is excessive in amount:

A. Depreciation reserves should be accumulated at reasonable annual rates paralleling those permitted by the Bureau in the case of taxable entities. For suggested rates applicable to various types of property, reference should be made to the Bureau's Bulletin "F".

Farmers' associations which have flagrantly overdepreciated their fixed assets lay themselves open to possible loss of exemption eligibility, perhaps even retroactively for any years when depreciation charges were excessive.

The practice is certainly indefensible from the viewpoint of fairness and equity for it unduly favors the patrons of the future to the detriment of those who preceded. A similar injustice exists where an association underdepreciates its assets or pursues an inconsistent or irregular policy by which assets are depreciated in widely fluctuating amounts between years, influenced sometimes merely by what the net savings happen to be, or by other equally unsound reasons.

B. Reserves (allowances) for uncollectible receivables should be set aside on a basis consistent with the past record of actual losses, or with an estimate of losses derived from an actual analysis and inspection of each receivable.

C. Capital reserves required by State law are not limited in amount at all, as previously mentioned. However, they must be combined with all other capital reserves in determining the allowable amount of the latter, as will be explained later.

D. Other capital reserves for definite purposes, of known or estimated amount, should be supported by proper calculations and other evidence of their necessity and amount. The burden of proving the needed amount is entirely on the association. (See pars. 442-445 for a discussion of reserves for operating losses.) Reserves for future expansion of plant, for example, could be supported by specifications and cost estimates prepared by an association's manager.

One Method of Determination

440. To determine whether capital reserves are excessive, their relation to liabilities, to other forms of capital, and to essential and nonessential assets must be considered. Thus, one method of determination is as follows:

A. Set down the net book value of all assets.

B. Deduct therefrom the book value of nonoperating or nonessential investments or other assets. This refers to items which are not

vital for the conduct of the association's normal functions. Whether such assets are capable of ready conversion to cash is a matter which might be taken into consideration by the Bureau.

It is possible that receivables due from patrons who also have an allocated interest in the reserves might be classed as a nonessential asset. This follows the theory that such patrons virtually enjoy the benefit of a cash distribution of the reserve without having an attendant liability to pay personal income taxes thereon. (See further reference to this point in par. 449.)

C. Deduct, also, the amount of excessive net working capital. This is done by subtracting the estimated amount of net working capital needed for normal requirements from the present net working capital. This assumes that the current assets are liquid enough to provide for the proper retirement of current liabilities.

D. To the resulting subtotal, add the full amount of noncurrent (i.e., fixed) liabilities, plus an allowance to cover any reserves needed for justified purposes of definite or estimated amount, whether or not such reserves actually are entered as such on the books. This includes reserves for future possible annual losses (see pars. 442-445) and for other specific contingencies. It does not embrace the type of reserves which merely finance essential assets, ordinarily termed "general purpose reserves." These are considered indirectly, however, by the method of calculation here used, as will be seen later.

E. The total at this point may be termed the "justified amount of net worth."

F. Determine the association's actual book net worth by adding formal capital and reserves (or "surplus"), or by deducting all liabilities (not including capital shares and equities) from total assets.

G. Compare the justified amount of net worth with the actual book net worth. The amount by which the latter exceeds the former is the excessive net worth. It is also the amount of excessive reserve unless the book reserves happen to be <u>smaller</u> than the indicated excess. In the latter event, the total amount of the book reserves is excessive.

441. The foregoing procedure is illustrated by a hypothetical balance sheet and calculation, as follows:

Balance Sheet

Assets		Liabilities	
Cash	$30,000	Current liabilities	$ 2,000
Other current assets	6,000	Fixed liabilities	9,000
Total current assets	$36,000	Total liabilities	$11,000
		Net Worth	
Nonoperating or non-essential assets, such as certain investments, etc.	$24,000	Capital stock	$10,000
		Reserves:	
		Required by State	5,000
		For pending lawsuit	9,000
		For estimated future operating losses	5,000
Fixed assets (net book value)	10,000	General purposes	30,000
		Total net worth	$59,000
Total assets	$70,000	Total liabilities and net worth	$70,000

Calculation of Excessive Reserve

Total assets			$70,000
Deduct:			
Nonoperating or nonessential investments		$24,000	
Excess net working capital:			
Current assets	$36,000		
Current liabilities	2,000		
Difference - net working capital	$34,000		
Versus estimated amount needed for normal requirements	12,000		
Excess		22,000	46,000
Subtotal			$24,000
Add allowances for necessary specific purposes:			
Retirement of fixed liabilities		$9,000	
Reserve for pending lawsuit		9,000	
Reserve for estimated future operating losses		5,000	23,000
Total "justified net worth"			$47,000
Versus actual book net worth			59,000
Amount of excessive reserve			$12,000

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Note: If, for example, the association expected to expand its plant in the future, which is estimated to cost $12,000 or more, then the foregoing calculation, when revised, would not indicate an excessive reserve.

Reserve for Operating Losses

442. The past record of loss years is perhaps as good a basis as any for the estimated amount of reserve needed to provide for future losses. However, as brought out in the foregoing calculation, the allowable amount of any reserve is determinable partly according to the amount of other capital. If the association has no past loss record it still may be able to reasonably justify a provision for meeting losses in one or more future years by reason of crop failures, unusual market conditions, etc. Just what limit would be placed on the number of years to be provided for, is uncertain.

443. One ruling on the subject, published by the Solicitor of Internal Revenue in 1924, known as S.M. 2286 (C.B. III-2), reads in part as follows:

> "The selling organization of the exchange is necessarily very large, and for sound business reasons must be continually maintained throughout the year, and even during years when the fruit crop is unusually small. During such years the exchange must be operated at a considerable loss. To take care of such contingencies, and to tide over the lean years resulting from crop failure or destruction, the exchange has accumulated and maintains a reasonable reserve, as is expressly permitted by article 522 of Regulations 45 and Regulations 62. [Now also permitted by Regulations 103.]
>
> "The reserve represents merely a small percentage of the proceeds from the sale of fruit, held by the exchange with the consent of the growers to meet emergencies that may arise. Relative to the reserve, it should be noted that it stands to the credit of the subexchanges and local associations and through them to the credit of the individual growers in the very proportion in which fruit is furnished by them, so that such part of the reserve as is not needed to meet losses will ultimately revert to the growers to whom it essentially belongs.
>
> "The total reserve amounts to considerably less than the average operating expenses for a single year, and probably would be exhausted within a year in case of a crop failure." [Underscoring and bracketed wording added.]

444. This gives some support to one year's loss as a measurement. It even may be thought to apply to the losses of more than one year, for in the average case the "operating expenses for a single year" probably would amount to as much as the losses for several years.

445. Various methods for allocating the losses charged to reserves are outlined in paragraphs 396-401.

Why Limited?

446. Apparently the underlying philosophy which impelled Congress to limit the amount of reserves is to maximize the distribution of funds to members and other patrons, placing income in their hands where it will augment the Government's tax revenue. In short, an effort to move exempt funds into taxable channels.

447. Another reason originally for the limitation of reserves was to keep at a minimum the amount of injustice or inequality to past patrons, both members and nonmembers, involved in the fact that reserves might be distributed upon dissolution, or even earlier, to the then-existing members or stockholders. This is no longer a factor as the application of the recent decisions handed down by the Federal Courts in the case of the Fertile Cooperative Dairy Association prevents this inequity. (See pars. 367-368 et seq.)

448. The effective recognition of each patron's interest in an association's assets has been in past years of some importance in the Bureau's consideration of reserves. This is illustrated through the following quotation taken from a letter written in 1939 by the Commissioner to one large cooperative:

> "...as the property rights in your surplus account appear to be fixed on a patronage basis, the question of whether more than a reasonable surplus is being maintained does not appear to be sufficiently material to determine the decision in this case."

449. It is obvious that taxing authorities are interested also in encouraging regular, periodic distributions of unneeded reserves in order to preclude the situation where an exempt cooperative may withhold such reserves during a period of high income tax rates, disbursing them to patrons at a later time when such rates have declined. Such a situation might arise either intentionally or unintentionally on the cooperative's part.

Academic Matter

450. This whole subject of excessive reserves seems to be more academic than practical, for very few cases thereon have been brought forward prominently by the Bureau and apparently none have been ruled upon by the Board or by the courts. In every case where reserves were questioned by the Bureau they were definitely and obviously excessive by any standards, without any need for the use of a measuring formula such as is outlined in paragraphs 440-441.

451. The foregoing is not intended to imply that cooperatives should relax on this matter and make no effort to distribute excessive reserves. (See pars. 421-422.) It is possible that the absence of rulings in the past has resulted from the fact that many farm cooperatives have not been prosperous enough to develop excessive reserves. Since a more successful cycle has been entered, perhaps more questions will arise about the amount of reserves.

Why Have Reserves?

452. A remedial measure may be adopted by an exempt cooperative whose manager or advisers feel that the amount of its capital reserves places the association in jeopardy of losing its eligibility for exemption. By taking proper corporate action, the portion of such reserves used to finance general assets and to provide for the retirement of debt or for

the future expansion of the business, may be converted into capital stock or other capital shares. A reasonable amount of reserve may be left for the absorption of future possible losses.

453. The foregoing plan could be carried one step further by eliminating all capital reserves. This however produces a somewhat undesirable situation in the event of a future loss year, where capital certificates are in use. An association is then faced with the alternative of calling in the certificates for pro rata reduction to absorb the amount of the loss, or of carrying such loss forward as a deficit account to be absorbed or reduced by future savings.

454. The credit standing of an association should not be affected detrimentally by the described conversion of reserves, since lending institutions or other creditors ordinarily are interested mainly in the adequacy of capitalization, rather than in its actual form.

Automatic Contributions

455. The foregoing refers only to the conversion of existing capital reserves. Future reserves also could be eliminated by a system of what may be called "automatic contributions." Under that plan, the bylaws would provide that all amounts remaining from business proceeds at the close of each year, after providing for the payment of costs and expenses, are to be credited to each patron in proportion to patronage and each such credit is agreed to be held by the association as a loan from patrons. Such loans could be stated to mature at either a short or long-term date, or only upon dissolution. They might, but need not, be evidenced by certificates of debt, notes, or other written instruments. Preferably they would carry no interest, or if interest is thought to be desirable, it should be set at a low rate.

456. A variation of that procedure is possible through a bylaw provision stating that the described annual overage shall become a capital contribution from each patron in proportion to his patronage. Capital stock, or other capital equity certificates, might or might not be issued to each patron for his contribution.

457. Because it might be held that nonmembers are not bound by an association's bylaw provisions, it probably would be desirable to have a separate, written agreement with each nonmember respecting his contributions. (See pars. 577-578.)

458. Under those plans an association technically would have no "profits," "gains," or net savings, other than what might be represented in extraneous forms of income. (See pars. 141-148 and 380-393.) Thus the requirement in certain of the State laws that cooperatives shall set aside annually a certain fixed percentage of their net savings apparently would not apply to associations operating under the automatic contributions plans. (See pars. 430-435 for a detailed discussion of State-required reserves. See also pars. 603-604.)

Benefits of Automatic Contributions

459. An important factor in the use of the described system of automatic contributions lies in the fact that if a cooperative association for any reason should lose its tax-exempt status retroactively for one or more years, it then would be in a position where the Federal income tax is assessable only on the organization's extraneous gains, if any. (See pars. 600-602.)

460. The mere allocation to patrons of their respective interests in an association's reserves does not change the essential nature of the reserves and, therefore, does not accomplish the result brought about by an agreement with patrons for automatic loans or automatic capital contributions.

Effect Upon Income of Patrons

461. In considering the possible adoption of one of the automatic contributions plans, it should be borne in mind that patrons who are subject to income taxation in all likelihood will be required by the taxing authorities to report as taxable income the amount of their contributions to the association for loan or capital purposes. For an exception to that conclusion, and for further information concerning the effect on patrons of their contributions, see paragraphs 306-313.

Revolving Capital

462. So as to avoid favoring future patrons to the detriment of present and past customers, by forcing the latter to bear the entire burden of capitalizing the association, a revolving plan of financing may be adopted as an equalizing device. By this means, when the described automatic loans or automatic capital contributions reach an amount which exceeds the association's capital needs, such excess is reduced by an equivalent cash retirement of the oldest series of loans or capital contributions.

463. Thus, a continuous rotation of capital is brought about. This is a truly mutual, cooperative method of financing, as capital is thereby contributed and held always in proportion to each patron's use (patronage) of the association.

Direct Contributions

464. Obviously, an association, if it so desired, could eliminate or minimize the amount of net overage each year by operating strictly on a cost basis, although in most instances it would be practically impossible, unless a pooling plan were in use, to so handle the business as to wind up annually with a break-even result.

465. Associations which attempt to operate in that manner, or which pool the sales proceeds of products along with expenses, usually rely for their sources of financing upon direct contributions from members and other patrons in the form of either loans or capital subscriptions. By direct contributions is meant payments received from outsiders or from patrons without any relation to the savings of the association. Such contributions might or might not be linked up with the amount of patronage. Sometimes they are arranged as an authorized deduction of a

certain percentage from the proceeds of patrons' products or as a fixed-amount levy on each unit of product handled for patrons.

466. The revolving-capital system could be employed also by an association which operates on the basis of direct contributions. For certain types of associations, a combination of direct contributions with automatic contributions would seem to be a desirable arrangement. The automatic feature would serve to eliminate any net savings, as such, from the association's operations.

Requirement No. 5

Patronage and Equity Records Must Be Maintained and Must Be Permanently Preserved

Present Regulations

467. On page 237 of Income Tax Regulations 103, published in 1940, appears the following comment:

> "In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating on a cooperative basis in the distribution of patronage dividends to all producers will suffice." [Underscoring added.]

Forthcoming Revision

468. The foregoing regulations merely call for the preservation of underlying records from which a determination of the business done with each patron could be made at some future time. These regulations, when reprinted, undoubtedly will be revised to coincide with the new requirements resulting from the Fertile Dairy decisions. (See pars. 366, 368, 369, and 378B.)

Actual Entry now Required

469. The final decision in that case was rendered by the Court on April 26, 1941. It is advisable if not actually necessary, therefore, for all exempt associations, beginning with the first fiscal year ended after that date, to keep an actual ledger account with each patron in which is posted the volume of his business with the association. This ledger need not show each transaction with its date and details but may be used merely to record the summarized total of such transactions with each patron. This should be indicated by either the unit volume or the dollar value, according to how the allocation of savings is to be made. (See pars. 264-273.)

470. In this ledger, also, should be recorded the actual amount of savings allocated to each patron. As a convenient designation it could be termed a patronage-equity ledger.

471. As a result of the decision mentioned, it seems advisable furthermore that the foregoing information be figured and entered in such a ledger for each past year which is represented in any capital reserves existing today. (See par. 378B for further information on this subject.)

472. From informal conversations with Bureau officials, it is understood that they have interpreted the Fertile Dairy decisions as requiring

the actual entry of patronage data and savings shares. Of course, such an entry, in itself, does not mean that the allocated savings must be paid immediately in cash. The time of payment ordinarily is within the discretion of the association up to the point where reserved savings do not become excessive. (As to excessive reserves, see pars. 438-445.)

Cost of Records

473. The expense of calculating and entering the patronage and allocation information is considerable for associations doing business with a large number of patrons. One manager recently stated it would cost his organization at least $4,000 annually in bookkeeping salaries. The new ruling, however, will cause only a small amount of extra work to the cooperative which has made patronage refunds regularly, since the refunding process embraces most of the necessary calculations.

Preservation of Records

474. As indicated by the term "permanent" in the regulations quoted in paragraph 467, it is believed that all patronage and equity records must be preserved throughout the life of an association. Moreover, they apparently must be held, along with the general books and records, for a considerable period after an association's dissolution. This is a definite requirement for taxable entities as is outlined in the following quotation from Income Tax Regulations 103 (page 218 thereof):

> "...such permanent books of account or records...shall be kept at all times available for inspection by internal-revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal-revenue law."

475. It is quite probable that the foregoing applies also to tax-exempt cooperatives. The responsibility for so preserving the records usually rests upon the secretary of the organization.

Requirement No. 6

Supplies and Equipment Purchased for Nonmembers Who Are Not Producers Must Be Limited

Limited to 15 Percent

476. As explained in paragraphs 406-415, purchases of supplies and equipment made by a tax-exempt cooperative for patrons who are not members, whether producers or nonproducers, must not exceed 50 percent of the total of such purchases. An additional limitation is imposed by the following clause appearing in section 101(12) of the exemption statute:

> "...provided the value of the purchases [of supplies and equipment] made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases." [Bracketed wording added.]

477. The 15 percent limit refers to supplies and equipment purchased and turned over to nonmembers who are not producers. This limit is included within the total nonmember allowance of 50 percent (not 65 percent). Thus only a 35 percent allowance is left for business with nonmember producers, if the 15 percent allowance is fully used for nonmembers who are not producers. Where the nonproducer element is less than 15 percent, the unused allowance therefor becomes applicable to the business done with nonmember producers.

478. It is important to note that the 15 percent rule is based only on the amount of total supplies and equipment purchased and turned over to patrons, not on other types of transactions such as marketing activities, etc.

Business Volume Basis

479. The exemption statute does not use the word "sales" apparently on the theory that a supply cooperative or supply department merely makes purchases as an agent for its patrons, thus delivering merchandise without a bona fide sale on the part of the association.

480. The purchase cost of merchandise to the association is, of course, different from the price at which it is billed to patrons. From conversations with Bureau officials it is understood that the billing price (which in cooperative accounting is often termed "sales" for lack of a more appropriate designation) is permitted as a basis for calculation of the 15 percent limit.

481. It is believed, further, that the purchase cost to the association of each patron's supplies, could be used also as a basis. Very few associations, however, keep their books so as to reflect this information. (See pars. 268H and 268I.) A gross margin basis cannot be used. (See pars. 269-273 and 408D.)

482. The Bureau has construed the 15 percent rule to apply also to any income received by an association in connection with services related to supply transactions. In that case, the dollar amount of the service fees received would be used as a basis.

483. A greater variety of bases is permitted for the allocation of net savings, which is explained at length in paragraphs 264-273.

Payers of Extraneous Income

484. Extraneous income not related to the supply department, and the payers of such income, need not be considered in calculating the 15 percent restriction. For a description of the type of income so excepted, refer to paragraohs 138-148 and 380-393. All types of services, however, that are not related to marketing must be placed in the supply department for consideration in the 15 percent bracket.

Nonfarmer Members

485. The 15 percent rule does not apply to members (those with a voting right) who happen to be nonproducers. However, the proportion of nonproducers who are voting members is very strictly controlled and limited by the terms of Requirement No. 7 (see pars. 490-503).

Transient Trade

486. Exempt associations, particularly oil cooperatives, dealing with city or town residents and transient customers, should continuously check their compliance with the 15 percent rule. The fact that such patrons are counted within the 15 percent limit does not relieve the association of the responsibility for treating them on an equal basis with other patrons in the allocation or distribution of savings. (For a further discussion of transient trade, see pars. 293-295.)

Departmental Separations

487. Where a marketing-purchasing cooperative's supply and equipment sales to nonmember nonproducers exceed the 15 percent limit, this may be remedied legitimately sometimes by the transfer of part of the sales to the marketing department. This can be done only if the origin of the products sold can be attributed to local producers. The following illustrations explain this situation: (See also pars. 124 and 212-219.)

A. A grain elevator association sells a considerable quantity of corn to local stores which resell it for feed purposes. This is classed by the association as nonmember nonproducer business in the supply department. If the corn concerned originated with, and was purchased from, local producers, both the purchase and sale thereof may be properly considered in the marketing department only. Under this plan, any allocation or refund of savings would be made to the producer, not to the local store. (But see pars. 296-297 explaining a method of paying two refunds.)

Conversely, purchases of corn from dealers (nonproducers) carried in the marketing department may be transferred to the supply department to the extent of a volume equaling the supply department's

corn sales, plus the corn on hand at the end of the accounting period. If such sales were made to producers the transfer would not detrimentally affect the 15 percent rule. On the other hand, it enables an elimination from the marketing department of the purchases from dealers. (See pars. 113 et seq. regarding such purchases.)

B. Another example is a grocery cooperative operating strictly as a farm supply organization and selling principally to local producers. It is practically forced to take in eggs from producers in trade for groceries sold to them. So many eggs are received in this manner that the cooperative becomes unable to dispose of them entirely to producer-customers and, therefore, is obliged to make sales to commercial egg handlers. This causes the nonmember nonproducer business to run above 15 percent.

There apparently is no reason, under such conditions, why the egg transactions may not be considered entirely as a marketing function, even though no other marketing is done. This restores the entire business to a tax-exempt basis. Authority to engage in marketing, of course, should appear in the association's legal papers.

Business for the United States

488. As outlined in paragraph 206, business done for or with the United States, or any of its agencies, including any service fees or commissions received therefrom, may be entirely eliminated in calculating the 15 percent restriction. Such transactions are separately classified in a manner similar to that described in paragraph 411. (Refer, also, to pars. 203-226.)

Cross-Index

489. Some definitions related to Requirement No. 6 may be found as follows:

Requirement No. 7

Substantially All Voting Rights Must Be Held By Actual Producers Who Currently Patronize the Association

Statutory Language

490. Section 101(12) of the exemption law contains the following clause:

"Exemption shall not be denied any such association because it has capital stock...if substantially all such stock [voting capital stock] ...is owned by producers who market their products or purchase their supplies and equipment through the association..." [Bracketed wording added.]

491. This might be understood more clearly if rephrased to state that voting rights in the hands of either nonproducers or nonpatrons must be kept at the absolute minimum.

492. Determination of what is "substantially all" is left to the administrators of the law. On this point the Bureau has not adopted any hard-and-fast policy, rulings being made according to individual circumstances, as described later.

Voting Rights

493. The right to vote, rather than the exercise of such right, is the governing basis for Requirement No. 7. Incidentally, there is no limit under the exemption statute as to the number of votes which each member may have. This differs from one of the alternate provisions of the Capper-Volstead Act, limiting each member to one vote.

494. While capital stock only is mentioned in the statute, it has been held to cover as well any other type of voting rights such as may be in use by nonstock associations.

Voting Rights Held by Nonproducers

495. When the voting rights were sold or issued originally to nonproducers, the Bureau permits only a very low tolerance, usually not more than 5 percent of the total voting rights. But where the rights were originally owned by producers and then were transferred to nonproducers through inheritance, etc., a more liberal allowance is permitted, especially if the association is making a diligent effort to have the shares or rights transferred to producers, or has not been able to purchase them, either because of a prohibition in the State statutes or because the necessary funds were not available. In circumstances similar to these, up to 10 percent[43/] has been allowed.

43/ This percentage is meant to be inclusive of all other types of questionable voting rights. In other words a 10 percent over-all allowance possibly may be permitted.

496. The following quotation is taken from page 238 of Income Tax Regulations 103:

> "The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption."

Voting Rights Held by Nonpatrons

497. It should not be overlooked that the statute requires substantially all of the voting rights to be held by active patrons. Up to 10 percent[44/] of the voting rights possibly would be allowed in the hands of farmers who are still producing in other sections, but who are no longer patrons, nor potential patrons.

498. Where local farmers with voting rights are not patronizing the association currently because of crop failures or other unavoidable causes, or even where they are temporarily dealing with other organizations for economic reasons, a still greater tolerance on the part of the Bureau is possible.

Desirable Procedure

499. Whenever any of an exempt association's voting rights are held by producers who have left the locality, or by nonproducers, it is believed advisable to report such fact to the Commissioner of Internal Revenue at Washington, D. C., for his opinion of the effect on exemption. This applies, as well, when any increase occurs in the proportion of voting rights held by nonproducers or by nonpatrons.

Possible Remedies

500. Sometimes an association which has been long established, particularly if it is incorporated with capital stock under the business corporation laws, gets into a position where a portion of its voting shares are owned by outsiders, often transferred to them through the death of members. When such transfers become substantial, the only solution may be to reorganize the capital and legal structure of the association. If this is not possible legally, it may be found desirable to abandon the organization and to form a new one to take over its assets and business.

501. Many farmers' cooperatives today, including some newly formed and others which have revised their organizational papers, are operating -

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44/ This percentage is meant to be inclusive of all other types of questionable voting rights. In other words, a 10 percent over-all allowance possibly may be permitted.

successfully on the modern, cooperative plan of revolving capital (see explanation in pars. 462-466). One version of that plan effectively prevents the difficulty under discussion since the voting rights of those who have ceased patronizing the association are revoked without the necessity of retiring their revolving capital shares.

502. An equally effective arrangement, adaptable particularly to nonstock cooperatives, is one which carries the stipulation that voting rights are canceled when a member fails to patronize the association within a prescribed period of time, or when he becomes ineligible for continued membership.

Cross-Index

503. Some definitions of interest in connection with Requirement No. 7 may be located as follows:

Requirement No. 8

Substantially All Capital Shares of Participating Type Must Be Owned by Actual Producers

Statutory Language

504. The following is quoted from section 101(12) of the exemption statute:

> "Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products through the association..."

Interpretations

505. The phrase "beyond the fixed dividends," as used in the foregoing quotation, is understood to mean that nonvoting preferred stock must have the same maximum annual dividend rate as any other stock. The quoted portion of the statute is construed further to permit either producers or nonproducers to hold nonvoting preferred stock of the type that is not entitled to full participating rights. The latter term, as used herein, is intended to indicate a right to participate upon or before dissolution in an association's savings over and above the allowable annual dividend rate.

506. The statute does not appear to specifically bar, nor to definitely authorize, the use of shares which, if owned by producers, would carry full participating rights upon dissolution. Full participation before dissolution is prevented, to be sure, by the limitation on the annual dividend rate.

507. The subject of full participation was discussed by the Acting Commissioner of Internal Revenue in Mimeograph 3886 of July 9, 1931 (C. B. X-2, 164) when he said:

> "If an association is permitted to have nonproducers as stockholders and accumulate a surplus at the same time, the principle that a producer shall have returned to him the proceeds of the sale of his products less only necessary operating expenses is violated. [This seems also true even if producers owned the stock, for their stockholdings rarely parallel their patronage.]
>
> "This follows as a result of the established principle of law that the surplus of a stock corporation inures to the benefit of its stockholders. [Then even if producers held all the stock, former producer-patrons would not receive their share of the surplus.]

"Therefore where associations are permitted by law to organize with capital stock, it is essential to exemption that the ownership of capital stock which carries the right to participate in the surplus and reserves of the association be restricted, as far as possible, to actual producers." [Bracketed wording added.]

508. It is clear that no type of capital shares in use by an exempt cooperative may have a dividend or interest rate per annum in excess of the limited rate permitted by the statute. But whether or not this rule would apply in the year of actual dissolution is uncertain. That is to say, would exemption be destroyed in the year of dissolution if full participating shares were retired in an amount which included liquidating dividends that exceeded the allowable annual rate for normal dividends?

509. If exemption is affected by such a distribution, the situation probably could be remedied by postponing dissolution for as many years as would be required to permit the payment of liquidating dividends in annual instalments that do not exceed the limited rate. (See also par. 386.)

Participation Now Restricted

510. The Fertile Dairy decisions of 1941 (see explanation in pars. 373-375) have the effect of restricting the participation of capital shareholders. As previously explained, all annual operating savings, as a result of those decisions, now must be allocated to each patron on a patronage basis in such a way as to become his property at least upon dissolution of an association, after satisfaction of creditors and the payment in face value, only, of any capital shares which may have prior rank, including declared or cumulative dividends on such shares.

511. Thus, a cooperative having a type of capital share which provides for full participation upon dissolution, will be obliged, if it desires tax-exemption, to make allocations to patrons of operating savings in such a manner as to prevent participation therein by the capital shareholders beyond the limited annual dividends. This applies whether such shareholders are producers or nonproducers. (See further details in pars. 373-375.)

512. The foregoing refers only to operating savings - those arising from transactions with patrons in the main operating functions of marketing, purchasing or related activities. Capital gains or other forms of nonoperating income may be handled so they inure to the benefit of shareholders. Annual distribution, of course, would be limited to the allowable rate. Whether this participation in the year of dissolution may exceed the allowed rate for normal dividends without affecting exemption is uncertain as discussed in paragraphs 508-509.

Capital Stock Cooperatives

513. Among some producers in certain sections of the country an antipathy exists toward farm cooperatives which are organized with capital stock. This probably arose because that type of financing ordinarily

is used by and identified with commercial, profit-motive corporations. Such a feeling hardly is justified toward the restricted type of stock which is permitted for exempt cooperatives under the exemption statute. A farmer's association, indeed, may be as truly cooperative under a capital stock form, as with any other type of capital. Naturally, that excepts the situation where control of a cooperative has become vested in nonproducers because there were no restrictions on the transfer of the organization's voting capital stock.

514. An exempt association's capital stock bears little real resemblance to the commercial variety chiefly because the former is not permitted to participate in operating savings or capital gains beyond a certain limited dividend rate as fixed by the exemption requirements. In actuality, this restriction makes the dividends analagous to mere interest. Commercial corporations, of course, sometimes have forms of limited stock but these are only in effect when there are superior forms, also.

515. Many cooperatives permit only one voting share to be acquired by each member, thus limiting the voting right. Another common provision found in the legal structure of some associations prevents the sale or other transfer of capital stock by shareholders unless approved by the association. This favors the retention of voting control by producers. Neither that provision nor the one-vote restriction is required to qualify for tax exemption. They are mentioned only as illustrations of some features not usually found in the stock of commercial corporations.

Requirement No. 9

The Rate of Dividends (or Interest) on Capital Shares Must Be Limited

Statutory Maximum

516. The following clause is quoted from the exemption statute:

"Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued..."

Maximum Interpreted

517. The two following examples interpret the statute's meaning:

A. If the State legal maximum interest rate (not the contractual interest rate maximum) is 10 percent, then up to that rate is permissible for annual dividends on capital shares.

B. If the State legal maximum is 6 percent, then a rate up to 8 percent may be used for dividends on capital.

Reason for Limitation

518. It is clear that if no restrictions were placed on the dividend rate, the shareholders of exempt cooperatives, if they were so inclined, could evade the responsibility of returning operating savings on a patronage basis by voting all savings to themselves in the form of capital dividends. The limitation of such dividends, therefore, tends to strengthen and perpetuate an association's cooperative character. The earlier income tax statutes made no mention of exemption for farmers' cooperatives having a capital stock form of organization.

519. In this discussion of the maximum rates allowed, it should be pointed out that the Farm Credit Administration does not favor high dividend rates on the capital shares of agricultural cooperatives. On the contrary, with conditions as they exist today it is unwise for cooperatives to fix capital dividend rates in excess of the interest rates they pay, or would have to pay, for borrowed funds.

Basis of Rate

520. The rate must be based on the consideration received for the capital shares. It is customary for farmers' associations to issue such shares only at par value. However, where stock or other capital shares are issued for less than par, or are issued on a no-par basis, the dividend or interest rate must be based on the issued value. Thus, for example, a $100 share carrying a 6-percent rate, if issued for $50 has an effective rate of 12 percent.

Nonstock Associations

521. For associations organized without capital stock, the rate limitation applies to the interest paid or accrued on whatever form of capital shares exists.

What Is a Capital Share?

522. It seems important to distinguish capital shares from liabilities credited to members or other patrons, since the interest rate on liabilities is not controlled by the exemption statute, but rather by the contractual rate maximum stipulated by State law. Sometimes it is difficult, particularly with nonstock associations, to make this distinction. As a general rule, credits without a fixed or determinable due date or those payable upon dissolution are regarded usually as equity capital, whether or not evidenced by a written instrument. (See pars. 376 and 653.)

523. Where credits to patrons arise from direct payments to the association, or through an authorized deduction from the sales proceeds of patrons' products, they may be either capital shares or liabilities for borrowed funds, according to the expressed or implied intention of the parties. If such credits are not payable until dissolution, except at the option of the association, they probably would be considered as capital. If a fixed due date exists, but no agreement on the nature of the contributions has been made, their status presumably would be uncertain.

524. In other phases of taxation, the Bureau of Internal Revenue has been faced with the necessity of differentiating between equity capital and borrowed capital. In those cases emphasis at times was placed on whether or not the obligation was interest-bearing. That is to say, if it did not carry interest this might tend to show it was equity capital.

525. From the viewpoint of exempt farm cooperatives this particular subject has not been explored fully. No doubt it will be difficult at any time to lay down precise, categorical rules since the Commissioner must be governed always by the individual facts in each case, from which he decides the nature of the credits.

526. For all practical purposes a capital equity in a cooperative association is any stated right or any stated monetary credit, whether certificated or not, that legally ranks after general creditors in the distribution of an association's assets upon its dissolution. If only one type of capital equity is in use, it carries a common law right to a proportionate share of any assets which may remain after all creditors have been satisfied. Thus, it is redeemable at face value, plus its share of any gain, or minus its share of any loss that may exist. Cooperatives desiring to be exempt from taxation must negative a part of this inherent right, as described in paragraphs 373-375 and 510-512.

527. Where an association has more than one class of capital shares, it is well to have their rank in liquidation stated clearly on the shares and in the bylaws or other legal papers. If a nonstock association does not have formal equities of a specific amount for each member, it is

likely that in the absence of provisions to the contrary, the members existing at the time of dissolution would have the right to share equally in the distribution of residual assets. (See pars. 384-385.)

528. Conversely to the foregoing, any credit to a person or concern which legally ranks on a level with, or superior to, general creditors is not a capital share. It may be a liability, or it may be in a third category - neither capital equity, nor liability. (See also par. 644.) An example of the third category exists where an exempt association, without any legal obligation, allocates its reserves on a patronage basis to patrons. Such credits technically might not be either capital equities or liabilities. The Fertile Dairy decisions (see pars. 373-375) should cause cooperatives to avoid that type of situation.

Noncumulative Dividends

529. The question often arises whether noncumulative capital share dividends not declared in prior years may be made up by payment at one time in the current year, if the total so paid does not exceed the aggregate amount allowable for the period of years concerned. For instance, if an 8-percent noncumulative dividend were passed for two years, could it be made up by declaring and paying a 24-percent dividend in the third year? A clear answer to this question is not available as no decisions have been published on the subject.

Cumulative Dividends

530. Where interest or dividends are cumulative they normally would be entered as a liability to be paid out of the first available savings. No question arises on this type, even though actual cash payment may be deferred indefinitely.

Form of Dividends

531. The rate limitation applies to dividends or interest paid in any form, whether by cash, in capital stock, in other certificated or uncertificated capital shares, by notes, or other written instruments.45/

45/ See Farmers Mutual Cooperative Creamery of Sioux Center, Iowa v. Commissioner, 33 B.T.A. 117.

Requirement No. 10

Legal Structure Must Be Cooperative in Principle and Must Not Contain Provisions Inconsistent With the Foregoing Requirements

Statutory Language

532. Under the Federal statute, farmers' associations are eligible for tax exemption when, among other things, they are -

"...organized and operated on a cooperative basis..."

533. The term "organized" is construed to refer generally to the organizational and other legal papers of an association, such as its articles of incorporation, bylaws, membership agreements, and marketing or other contractual agreements with patrons, etc.

Content of Legal Papers

534. The quoted portion of the statute is further interpreted to mean that such legal papers, at least one of them, must contain provisions which clearly show the organization's intention to operate on a cooperative or mutual basis, granting such rights to members and other patrons as are consistent with that plan of operation.46/

535. In practice, the foregoing applies mainly to the older cooperatives which were organized under the general corporation laws before the State cooperative acts came into effect. Generally those incorporated under the latter acts would have a legal structure of the proper type.

536. If a new cooperative association chooses to incorporate under the general laws in a State which already has a cooperative act, its claim for tax-exemption will come under close scrutiny by the Bureau. While the bylaws of such an association would prove its cooperative nature, it nevertheless could change the bylaws in its discretion and possibly without the Bureau's knowledge.

Contrary Provisions

537. On the other hand, it is quite important that the legal papers do not contain provisions which could be held as contrary to, or inconsistent with, a cooperative plan of operation, which plan is defined through the detailed requirements of the exemption statute and its official interpretations as already outlined in the foregoing pages.

538. While as a general rule, any such contrary provision which has been carried out will cause a loss of exemption eligibility, it might not so result if the Commissioner of Internal Revenue should feel that the infraction is relatively unimportant.

46/ For suggested organization forms, see Sanders, S. D. Organization of Farmers' Cooperatives. F.C.A. Cir. C-108, 42 pp. 1939. See pp. 15 et seq. thereof.

Unexercised Contrary Provisions

539. If a contrary provision never has been put into effect, the question of whether or not it will destroy exemption is a matter which can be decided only by the Commissioner. It is likely that here again he will be guided by the relative importance or the character of the provision.

540. It seems improbable that an objection would be made to the mere existence of a statement in the legal papers authorizing the association to engage in nonexempt business activities, when such activities never have been undertaken. A situation of this kind would be represented for instance by charter authority to market farm products for nonproducer dealers, a prohibited activity.

541. Conversely, it is believed that provisions similar to those described in the following illustrations, even though unexercised, might cause a loss of eligibility for exemption:

Typical Illustrations

Discrimination

542. - - where any discrimination is indicated among members, or between members and nonmembers, as to pricing, the rate charged for service fees, the rate of allocation or refund of savings, etc.

Treatment of Nonmembers

543. - - where the bylaws state that nonmembers are to be excluded from patronage allocations or refunds, despite the past practice of the association in treating them on a basis equal with members.

544. If this defect is corrected by revising the bylaws before the close of an association's fiscal year, with the revision made retroactively applicable for the entire year, it is possible loss of exemption might be avoided for the year concerned. It is unlikely that such a procedure taken in one year would be permitted to remedy the condition of any prior year.

Silent Bylaws

545. - - where the bylaws are silent as to the interest of nonmembers in savings. If the past practice was to actually pay refunds to such patrons on a basis equal with members, probably no objection will be raised by the Bureau.

546. However, if the association's past record is one of losses, or if it has made no actual distribution or allocation of savings and there is, accordingly, no evidence of the actual treatment accorded nonmembers, the Bureau often has considered this as a basis for declaring associations nonexempt.

Dividends on Capital

547. - - where provision exists for dividends or interest on capital shares at a rate higher than is allowable by the exemption statute, or where such rate is indefinite or not limited, even though past payments or declarations were all within the atatutory requirement.

Forfeiture of Equities

548. - - where a bylaw provision calls for the forfeiture or capital equities or any other type of credits when a member or nonmember ceases to be a patron.

549. No comprehensive rule has been laid down by the Commissioner on this subject, although the Bureau did not object in one recent unpublished case to a bylaw provision calling for the forfeiture of equities in the association's reserves where the patron's withdrawal occurred within an agreed 5-year period. It is possible, of course, that the Bureau's decision might have been different if the withdrawal period had been longer or had no limit at all.

550. There probably would be no objection to a forfeiture which did not exceed what could be held to parallel a reasonable amount of liquidated damages to an association. Cancellation or forfeiture of equities or credits of moderate amount probably would not be questioned, particularly if the arrangement were agreed upon between the parties. (See also pars. 334-335.)

551. An acceptable accounting treatment for such forfeited equities or credits would be to take them into miscellaneous income where they become a part of the year's savings for distribution on a patronage basis to the patrons of the current year. Another plan is to credit them to present holders of reserve equities in proportion to their holdings. A third method is outlined in paragraphs 384-386.

Dealer Business

552. - - where the bylaws or marketing agreements of an association permit the acceptance of products from members that they have purchased from others, whether from producers or dealers.

553. Even if this practice is not in actual operation, it seems that such a provision might be ruled undesirable for it would have a tendency to encourage among members a covert handling of such transactions.

PART III

NONEXEMPT (TAXABLE) FARMERS' COOPERATIVES

General Position

Tax Statutes and Regulations

554. What about a farmers' association which, for one reason or another, cannot qualify or does not wish to qualify, for tax exemption? First, it is important to understand that none of the requirements for exemption, as described in the foregoing pages, apply in any respect to a taxable (nonexempt) organization.

555. With certain exceptions to be outlined, such associations are bound rather by the same statutes (Internal Revenue Code) and regulations as are applicable to any taxable commercial corporation with respect to the filing of Federal income tax returns and the reporting thereon of taxable income. They are subject, also, to other Federal taxes, as will be described.

Taxable Status Sometimes Preferred

556. While it is held generally that the requirements for tax exemption harmonize with true cooperative principles, some farmers' associations nevertheless prefer to have a nonexempt status in situations where the management deems it more advantageous to be taxed than to meet the statutory conditions for exemption.

557. One common example of this is an association with a substantial or preponderant nonmember business where payment of income tax on the gain resulting from such business is preferred to the necessity for the allocation or refund of such gain to the nonmembers, the latter procedures being required for tax-exempt organizations.

Income Tax Liability

558. Under certain conditions as hereinafter outlined, nonexempt cooperatives have been permitted to exclude from their gross income in computing taxable income the amount of savings actually refunded or set up to be refunded to patrons.47/ Although tax returns must be prepared and filed each year, such associations would have little or no income tax to pay if their entire operating savings were distributed annually to all patrons on a patronage basis pursuant to a legal obligation to make such a distribution.

559. It is realized, of course, that few nonexempt organizations would operate normally in the described manner. Usually they do not wish to make equal distributions to nonmembers. Furthermore, they often find it desirable or necessary to withhold some of the savings for capital reserve purposes, or to pay some of them in the form of dividends on capital shares.

47/ I. T. 1499 (C.B. I-2, 189) (1924).
S. M. 2595 (C.B. III-2, 238) (1924).
G. C. M. 12393 (C.B. XII-2, 398) (1933).

Pool-Type Cooperatives

560. Nonexempt cooperatives which operate on a pooling plan (see description in pars. 250A, 252, 255, and 261) normally would have no taxable income beyond any represented by extraneous income (defined in pars. 141-148 and 380-393) or by any dividends or interest paid or accrued on capital stock or other capital equities (see dividend discussion in pars. 683-687).

No Partial Exemption

561. For many years the Bureau of Internal Revenue has permitted the described exclusion of refunds from gross income when certain special conditions are met. Such exclusions are erroneously believed by many people to represent a partial exemption. That feeling, perhaps, has some foundation from a nontechnical viewpoint. Actually, however, the exclusions simply represent a permitted method of arriving at the true taxable income, since the amounts excluded are not regarded as statutory income.

562. That viewpoint is represented in the following quotation from the Bureau's ruling I.T. 3208 (C.B. 1938-2, 127):

> "Under long established Bureau practice, amounts payable to patrons of cooperative corporations as so-called patronage dividends have been consistently excluded from the gross income of such corporations.
>
> "The practice is based on the theory that such amounts in reality represent a reduction in cost to the patron of goods purchased by him through the corporation or an additional consideration due the patron for goods sold by him through the corporation.
>
> "As such amounts are not includible in gross income of the corporation, they are obviously not deductible by it, though, where they have been erroneously included in gross income in the first instance, the correcting adjustment is sometimes loosely termed a deduction."

563. Thus, fundamentally, there is no such thing as partial exemption.48/ A cooperative organization which is exempt comes under the rules of exemption as set forth in section 101(12) of the Internal Revenue Code. (See part II hereof.) On the other hand, an association that is not exempt is subject to tax upon any statutory net income, the computation of which is governed by other sections of the Code and by the Bureau's Regulations.

No Applicable Statute

564. The existing Federal statutes do not outline the conditions governing the described exclusion of patronage refunds. The matter rests entirely within the scope of the Bureau's administrative practice which apparently has been generally accepted by the Board of Tax Appeals and the Federal Courts.

48/ So mentioned in Farmers Union Cooperative Oil Co. v. Commissioner, 38 B.T.A. 64 (1938).

565. One Federal Court in a recent decision[49] took occasion, in what appeared a critical vein, to remark about the "liberality" of the Commissioner in permitting "deductions" for which no statutory authority exists. While the context of the decision does not clearly indicate the Court's meaning, it is presumed reference was intended to cases passed by the Bureau where certain fundamental conditions were not insisted upon.

566. Competent legal authorities believe that if certain conditions (as hereinafter outlined) are fully met, no statutory authority is needed to make the described exclusions from gross income, as the items concerned would not be held to constitute taxable income to an association. Apropos of this, the Board of Tax Appeals made the following statement in one recent decision:[50]

"Both parties recognize that there is no specific statutory provision for the deduction of patronage dividends from the gross income of a cooperative association. The Treasury Department, however, as pointed out in Fruit Growers Supply Co., 21 B.T.A. 315, 326; affd., 56 Fed. (2d) 90, with 'great liberality' has allowed such deductions 'to the end that substantial justice may be done to an association which is engaged in cooperative marketing or purchasing work but which may not be exempt from taxation.' The justification for the ruling rests upon the fact that the so-called dividends are in reality rebates upon the business transacted by the association with its members rather than true income to the association." [Underscoring added.]

567. The Bureau's position is further stated in General Counsel's Memorandum 17895 (C.B. 1937-1, 56) from which the following is quoted:

"So-called patronage dividends have long been recognized by the Bureau to be rebates on purchases made in the case of a cooperative purchasing organization, or an additional cost of goods sold in the case of a cooperative marketing organization, when paid with respect to purchases made by, or sales made for the account of the distributees.

"For the purpose of administration of the Federal income tax laws, such distributions have been treated as deductions in determining the taxable net income of the distributing cooperative organization. Such distributions, however, when made pursuant to a prior agreement between the cooperative organization and its patrons are more properly to be treated as exclusions from the gross income of the cooperative organization. (I.T. 1499, C.B. 1-2, 189; S.M. 2595, C.B. III-2, 238; G.C.M. 12393, C.B. XII-2, 398.)

"It follows, therefore, that such patronage dividends, rebates, or refunds due patrons of a cooperative organization are not profits of the cooperative organization, notwithstanding the amount due such patrons can not be determined until after the closing of the books of the cooperative organization for a particular taxable period.

49/ Cooperative Oil Association v. Commissioner, (C.C.A.), 115 F. 2d 666 (1941).

50/ Midland Cooperative Wholesale v. Commissioner, 44 B.T.A. 824 (1941).

"In view of the foregoing, it is the opinion of this office that such patronage dividends may be excluded in determining the amount of the undistributed net income of the cooperative organization subject to the surtax imposed by section 14 of the Revenue Act of 1936, provided the liability therefor is set up on the books of the cooperative organization pursuant to corporate action taken with respect thereto prior to the close of the particular accounting period.

"This memorandum is applicable only to true cooperative organizations. The burden of proof is upon an organization to substantiate by competent evidence any contention it may make in that respect." [Underscoring added.]

568. The intention of the reference to a "true cooperative" is not clear. It would seem that any concern, even an organization not incorporated under the cooperative statutes, which legally obliged itself by "prior agreement" to make patronage refunds, perforce would be entitled to exclude them from gross income.51/

Refunds to Members Only

569. Some nonexempt farmers' cooperatives make refunds of savings to members only, ignoring nonmembers. While such refunds are permitted, the Bureau will allow as an exclusion from gross income only the portion of the refund which is found upon calculation to be applicable to the business actually done with members.

570. Put differently, an association is taxed on the savings arising from nonmember or even member business whenever, among other conditions, such savings are not refunded, or set up as a refund payable, to the particular patrons from whose business the savings arose.52/ (See pars. 664-667 for basis of computation.)

Detailed Requirements

571. In order that an association may exclude the described refunds, they must be calculated and otherwise handled in a particular manner. In addition, certain legal or corporate requirements must be observed. All of these conditions are discussed in detail on the following pages, under the headings shown below:

51/ See Uniform Printing & Supply Co. v. Commissioner, 88 F. 2d 75 (1937).

52/ A.R.R. 6967 (C.B. III-1, 290) (1924).

Legal or Corporate Requirements

Necessary Legal Provisions

572. One of the main requisites for the exclusion of patronage refunds from a cooperative association's gross income in computing its Federal income tax, is the existence of a proper legal foundation for the making of such refunds. Thus, in an ideal situation preferably all, but at least one, of the organizational or other legal papers should contain a positive and definite obligation to make such refunds either to all patrons or to members only, as the association may choose.

573. The papers referred to consist of the charter, the bylaws, and any membership, marketing, purchasing or other contracts with members or other patrons.

574. The agreement to make patronage refunds should be so clearly worded as to leave no doubt that it constitutes a binding obligation equivalent to a legal debt. Any lesser arrangement may prevent an association from excluding the refunds in computing its taxable income.

575. An association incorporated under a State cooperative act may find, by virtue of the controlling provisions of such act, that it qualifies automatically as to its legal obligation to make definite refunds. If any doubt exists, however, as to the clarity of the act's provisions in this respect, it is believed better not to rely upon them but rather to include the refund obligation in the association's own legal papers.

576. Reference herein to the making of patronage refunds is not intended to imply that they must be paid immediately, nor is it meant to preclude their payment in noncash forms. The maturity and manner of payment may vary as is discussed fully in paragraphs 598-599, 626-628, and 648-655.

Agreements with Nonmembers

577. It is rare that taxable cooperatives desire to make refunds to nonmembers. However, if refunds are to be made to all nonmembers, or to selected nonmembers, it seems desirable, if not absolutely necessary, to have a separate agreement with each such patron in which the association obligates itself to make a patronage refund. This follows since the charter or bylaws ordinarily would be held to represent an agreement with members only. The agreements with nonmembers preferably should be in writing and executed copies thereof should be retained by the association.

578. There are some who believe that separate agreements with nonmembers are not necessary. They contend that if the bylaws oblige the association to make refunds to nonmembers it becomes a binding obligation because the nonmembers may be said to have dealt with the association on the basis of its legal structure. This would seem more pertinent in the States where associations are required to file their bylaws of record with the Secretary of State or where the nonmembers had been specifically informed of the bylaw provisions. The nonmembers then could make a more

definite claim for refunds if the publicized bylaws provide for refunds to such patrons, or if the bylaws do not bar the making of refunds to nonmembers. (See also par. 602.)

Whose Income Is It?

579. Where a definite obligation exists in advance to refund on a patronage basis at the close of each fiscal year all amounts remaining from the proceeds of the business, after providing for costs and expenses, such refunds when paid within the same year, or when declared as a payable within the same year, cannot be considered in the opinion of the writers as the income of the association. It is the income of the patrons and thus is taxable to them, not to the association. (Under certain conditions the refunds are not taxable income to particular patrons. This is discussed in pars. 306, 310 et seq.) The association merely has custody of the concerned funds until their return to the "owners" thereof, who are the patrons of the particular year.

Indefinite Provisions

580. Unfortunately, many if not most cooperative associations do not have their legal papers drawn in such a manner as to clearly bring about the described situation. Where the legal papers are indefinite or vague and could not be construed to include a clear obligation to make patronage refunds, an association's claim to exclude refunds from its gross income is weaker. In such a case, there might be a basis for the view that at the time of receipt by the association the amounts concerned actually were the income of the association, 53/ whose taxation on such income is not eliminated by its distribution in the form of refunds.

581. If that position were taken, it probably would apply not only to refunds which are accrued as a payable before the close of a fiscal year by resolution of the directors, but as well to refunds which actually had been paid within the fiscal year on business of that year.

582. A refund made under the described indefinite circumstances conceivably might be considered by the taxing authorities merely as a voluntary payment in the nature of a gift, or as somewhat analagous to a dividend on capital shares. If so, the distribution could not be deducted by an association in computing its taxable income. 54/

53/ See Peoples Gin Company, Inc. v. Commissioner, 41 B.T.A. 343 (1940). Aff. 118 F. 2d 72 (1941).

54/ Gift contributions by corporations are deductible as a business expense if for certain well-defined purposes and within certain limits as outlined in sections 19.23(a)-13 and 19.23(q)-1 of Income Tax Regulations 103. These purposes are not related to the subject discussed above. That dividends on capital shares are not deductible by the issuer is covered in section 19.115-1 of Regulations 103.

Undeclared but Allocated Credits

583. It is quite probable that savings which an association is not obliged to refund and which are merely allocated to individual patrons on a patronage basis without their declaration by the directors as a payable, will not be permitted as an exclusion from gross income in computing the association's taxable income. The allocation alone does not establish the credits either as a definite capital equity, or as a definite payable. If such voluntary credits are declared as a payable, there still is some question as to their exclusion from gross income. This is discussed further in paragraphs 589-594 et seq.

Amount To Be Refunded

584. The arrangement to make patronage refunds at the end of each fiscal year, as set forth in a cooperative's legal papers, usually covers the distribution of one of the following amounts:

A. Total net operating savings. (This excludes nonoperating and capital gains. It could be provided, of course, that such items are to be refunded not to the payers thereof, but to the association's ordinary patrons in proportion to their patronage. Any amounts so refunded, however, could not be excluded from gross income since they did not originate from transactions with the persons to whom distribution is made. This is further explained in pars. 677-678.)

B. Total net operating savings, less specifically-named amounts to be withheld by the association for working funds or for other capital reserve purposes. The latter withholdings are sometimes fixed as a certain percentage of the net savings, or as a stated amount per unit of product handled, etc. They probably would be held taxable as income to the association even though allocated to the credit of individual patrons on a patronage basis, unless the legal papers clearly show that the members or other patrons authorized the withholdings as a loan to the association or as a definite contribution toward the purchase of its capital shares or other capital equities. (For a further discussion of loans and capital contributions, see pars. 600-602. See also pars. 464-466.)

C. Total net operating savings, less capital reserves in an amount to be determined by the directors in their discretion. (A provision of that type obviously leaves open the possibility of not making any refund in a particular year, or in any year.)

585. The first step in establishing a sound basis for the exclusion of patronage refunds from gross income is brought about when an association, through its organizational papers or other agreements, is mandatorily obligated in advance to refund the amounts described in either item A or item B, above.

586. There is, however, no assurance that the Bureau of Internal Revenue would consider situation C as the equivalent of a definite obligation for the reason that the making of refunds is optional. Where

situation C exists and refunds are made, it is possible that an association's claim to exclude the refunds from gross income might have more weight if, as a supplementary measure, the corporate action described in paragraphs 607-613 is taken.

Refund Classes

587. From the foregoing it is seen that the character of an association's legal papers determines whether a patronage refund may be classed as obligatory, optional, or voluntary.

Optional or Voluntary Refunds

588. In deciding whether the optional or voluntary type of refunds should be excluded from gross income, the taxing authorities probably would consider such questions as the following: Do the association's legal papers indicate a cooperative or mutual plan of operation, even though they may not provide explicitly for patronage refunds? What is the association's past record regarding the payment of refunds? Have they been accrued or paid regularly? The answers to these and other questions might have a bearing on the decisions of the Commissioner, the Board, or the Federal courts.

Paid or Accrued Refunds

589. A claim for the exclusion of the optional or voluntary type of refunds is undoubtedly strengthened when the association through formal resolution of its directors, or through vote of its members, declares the refund and accrues it on the books as a payable within the year in which the patronage arose. Stronger still might be the claim when the refunds actually were paid within the concerned year, or within a short time thereafter, say before the filing of the association's income tax return (a two and one-half months' period is permitted for filing). (See pars. 621-625. See also pars. 614-617 for a discussion of declarations made in the current or in the following year.)

590. There is at least some basis for believing that the foregoing procedure would be held to permit the exclusion of refunds from gross income where no clear-cut obligation to make refunds exists in the legal papers. This would be true if the taxing authorities decided to follow the theory that the nature of transactions between an association and its patrons need not be fully or definitely stipulated at the time of the transaction, but may be determined at any time within the taxable year and be held as applicable to the entire year. Some argument for this view lies in the fact that income taxation basically is measured with respect to the composite situation developed within a whole 12-month period, rather than on the basis of what occurs from day to day. No written authority exists either for or against that viewpoint. Thus, it must be considered a wholly speculative theory.

591. Perhaps a more reasonable basis for a cooperative's claim to exclude optional or voluntary patronage refunds from gross income lies in the viewpoint that the payment or accrual of such refunds (within the same year, as already described) may be said merely to represent a normal function of a true cooperative. Since a cooperative then is

expected to make refunds, there are some who believe it should be permitted to exclude the refunds whether or not the legal papers happen to contain a binding obligation to make refunds. That argument embraces the theory that the accrual of refunds, or more certainly their actual payment, is tantamount to an indication that there must have existed an implied though unstated obligation therefor.

592. Those who advance that theory would apply it also to any amounts left over from operations which were credited to each patron in proportion to patronage and which the association through a directors' resolution chose to consider either as a loan from the patrons or as a contribution by them to the association's capital shares or other equities, despite the fact that the legal papers make no mention of loans from patrons or capital contributions therefrom.

593. No definitive information is available to indicate how the taxing or the judicial authorities may view the foregoing theories. To be sure, there are possible objections. For instance, it might be doubted that an optional or voluntary refund could be converted into a definite liability or into capital equities merely by the action of one of the parties, that is by declaration through a directors' resolution, or even through vote of the members themselves. (But see par. 595.)

594. In most States a corporation's declaration of a dividend on capital stock becomes a binding legal obligation for the payment of which the stockholders would have a right to bring suit. It is not clear that this would be held to apply to the declaration of patronage refunds where an association's bylaws or the statute under which the association is incorporated, do not mention refunds or merely authorize the directors to pay refunds in their discretion. The point seems debatable. So far as the writers know, it has not been ruled upon clearly by either the Bureau, the Board, or the Courts. 55/

Cooperative-Commercial Contrast

595. The position of a commercial corporation with respect to the creation of a liability seems to be somewhat different from that of a cooperative, particularly where the latter deals with members only, or makes patronage refunds to members only. The members of such a cooperative, having beyond question the power to create a liability to themselves through a bylaw provision, conceivably might be held to have a parallel power to create a liability of equal obligation in other ways, possibly through the action of the association's directors who, of course, are duly elected by the members.

596. Again, there is an absence of any clear ruling or decision on the foregoing viewpoint. Perhaps a nonexempt cooperative's claim to exclude patronage refunds, particularly if its legal papers do not create an

55/ But see Fruit Growers Supply Co. v. Commissioner, 21 B.T.A. 315 (1930). Aff. 56 F. 2d 90 (1932).

obligation to make such refunds, might be strengthened when the refunds are declared by direct vote of the members themselves. This assumes, of course, that the members as a matter of law, are not barred from so doing.

Refunding Program

597. There is no reason why an exempt or a nonexempt cooperative association should not obligate itself definitely to make patronage refunds regularly each year. Such a program need not prevent an association from obtaining sufficient funds for working capital purposes. That could be arranged merely by having the bylaws provide that the payment of patronage refunds shall be deferred until dissolution, or shall be given a stipulated short or long-term maturity.

598. Or, the bylaws could include a plan to pay patronage refunds either in cash or in noncash forms at the option of the association. Such noncash forms would include notes, bonds, certificates of debt, certificates of capital stock or other capital equities, etc.

599. These procedures would permit the association to accumulate needed working capital, yet would not prevent it from excluding the refunds in computing taxable income, provided, of course, that the refunds were obligatory. (See pars. 648-655.)

Automatic Contributions

600. A quite similar arrangement is possible, also, through the use of a plan whereby the patrons agree that all annual overages are to be considered as contributions to the association for either loan or capital purposes. For a full description of these plans, see paragraphs 455-463.

601. It is believed that a bylaw provision for such automatic loans or automatic capital contributions would enable a nonexempt cooperative association to exclude the concerned amounts from its reportable income for taxation purposes. The Iowa ruling, discussed in paragraphs 652-655, is cited as authority for the deferment of refunds, and for the Bureau's conclusion that such deferred refunds are in actuality automatic capital contributions. There are some who feel skeptical that the Iowa ruling would be held as applicable in States other than Iowa. The writers do not share that view.

602. As mentioned in paragraphs 577 and 578, it is not certain whether the bylaws would be held to constitute an agreement with nonmembers, particularly where the nonmembers had not been advised specifically of the bylaw terms. Therefore, in order to apply the automatic contributions plans to nonmembers, it may be preferable to have separate agreements to that effect with each such patron.

Reserves Required by Law

603. Many of the State cooperative acts require farmers' associations incorporated thereunder to set aside annually a certain percentage of their net savings into a capital reserve until the latter reaches a specified amount, usually a certain named proportion of formal capital.

604. Under the refunding program outlined in paragraphs 598 and 599, any reserves required by the State law would have to be set aside first out of net savings. However, where the automatic contributions plan is in effect, as described in paragraphs 600-602, technically there are no net savings, as such. Thus, it is possible that a cooperative operating in that manner might not be affected by the State reserve requirement, unless, of course, the State authorities should rule otherwise.

Legal Aspects Unsettled

605. The unsolved questions in some of the preceding paragraphs illustrate some of the complications which confront the Bureau, the Board, and the Courts in deciding upon cases where refunds can be regarded only as of an optional or a voluntary character. It is obvious that the precise facts in each particular case must be analyzed before a decision is possible. On the other hand, associations which are legally obliged to make refunds in the manner described in paragraphs 572-576, should have no difficulty with their claim to exclude the refunds from gross income. This assumes, of course, that the refunds are prooerly declared and computed in the manner hereinafter set forth.

Refund Declaration

606. Where an arrangement for automatic contributions exists, such as is described in paragraphs 600-602, or where an association has a strong and clear obligation to make refunds annually, it is possible that the amounts concerned might be held by the Board or the Courts to be excludable from gross income even though no annual declaration is made by the association's members or by the directors.

607. Nevertheless, if an association wishes to be on the safe side, its directors or its members should specifically declare each refund, regardless of its legal foundation, before, not after, the close of the association's fiscal (taxable) year, if the refund is to be claimed as an exclusion from the gross income of that year. 56/ It may be declared in, and excluded from, the succeeding year's gross income, if desired, as outlined in paragraphs 614-617.

608. The intended manner of payment, whether by cash or in noncash forms, should be stated in the declaration resolution. It is assumed that payment in forms other than cash (see pars. 648-651) would be authorized in the bylaws, or by other specific agreement between the association and the refundees. The intended time of payment, whether before or upon dissolution, also should be set out in the resolution (see pars. 626-628).

609. In summary, the declaration resolution is believed advisable whether the refund is deemed to be obligatory, optional or voluntary;

56/ See Fruit Growers Supply Co. v. Commissioner, 21 B.T.A. 315 (1930). Aff. 56 F. 2d 90 (1932).
See Farmers Union State Exchange v. Commissioner, 30 B.T.A. 1051 (1934).
See Midland Cooperative Wholesale v. Commissioner, 44 B.T.A. 824 (1941).
See Cooperative Oil Association v. Commissioner, 115 F. 2d 666 (1941).
See pars. 589-590 herein.

whether or not the refund is accrued or actually is paid within the year in which the business with patrons originated; and whether the association reports for taxation on the cash basis or on the accrual basis of accounting. Most cooperatives today, however, keep their accounts on the accrual basis.

610. The resolution, furthermore, should declare the refund as a definite, unconditional liability. (On this, see pars. 635 and 644-646.)

Advance Declaration

611. Where any doubt exists that an association's legal papers clearly authorize it to withhold annual overages as loans or capital contributions from patrons, or where it is doubtful that the association is definitely obliged to make patronage refunds either in cash or in non-cash forms, it might be advisable for the directors, or the members themselves, to declare a refund by a written resolution in advance of the taxable year. Such a resolution should state in general terms the association's intention to refund a particular part (percentage) or all of the year's operating savings or overages, if any result.

612. It seems important to bring such a declaration to the attention of prospective patrons. Perhaps that could be accomplished effectively by posting an appropriate notice at the association's place of business. It then might be claimed that the patrons dealt with the association on the strength of the promised refund. Another declaration just before the close of the year should be made, also.

613. All nonexempt cooperative associations might consider the advisability of adopting the foregoing procedure as a precaution against the possibility that its organizational or other legal papers might not be considered by the taxing authorities to represent a sufficiently definite obligation to make patronage refunds.

Year of Exclusion from Gross Income

614. If the resolution described in paragraphs 607-610 is not made before the close of the fiscal year, say for example before December 31, 1941, it may be made under the Bureau's practice at any time during 1942 covering the 1941 refund, the amount of which may then be excluded from the 1942 gross income.

615. The Bureau will not permit this to be done for more than one year in arrears. Using the foregoing illustration, this means that refunds based on 1940 patronage and savings could not be excluded from the gross income for 1942.

616. It follows, also, that not more than one year's refunds may be excluded from any one year's gross income. Thus, if the 1941 refund is excluded from 1942 gross income, then the 1942 refund must be excluded from the gross income for 1943.

617. It is seen that this procedure may bring about an incongruity in that it is conceivable the 1941 refund may exceed the total amount of the 1942 savings. In such an instance, the association would lose the exclusion benefit of the amount of such excess.

Amount Declared

618. Since it is impossible ordinarily to close the books and determine the exact amount of savings or refunds within the fiscal year, it has been the practice of the Bureau (see par. 567) to permit the declaration resolution to be worded in general terms without an actual dollar amount. A satisfactory method for associations which report for taxation on the accrual basis is to state the refund as a certain percentage of the total net savings which are to be ascertained later when the books are closed. (For a discussion of refund entry, see par. 663.)

Refund Payment Requirements

Maturity of Refunds

619. Where a nonexempt association reports for income taxation on the cash basis of accounting, the patronage refunds (assuming other factors are properly complied with) to be excludable from the association's gross income of a particular tax year must be paid actually within that year. If one year's refunds are paid in the following year, they could be excluded as outlined in paragraphs 614-617.

620. Associations reporting on the accrual basis, after proper declaration of the refund, should accrue it on their books and have it appear as a payable item on the organization's balance sheet in the tax return, as already explained.

621. There has been some feeling that the Bureau would not approve an association's exclusion from gross income of such accrued refunds if they were not paid actually within a reasonably short period after the close of the taxable year. That feeling no doubt originated from the terms of section 24(c) of the Internal Revenue Code. That section reads as follows:

> "(c) Unpaid expenses and interest.- In computing net income no deductions shall be allowed under section 23(a), relating to expenses incurred, or under section 23(b), relating to interest accrued-
>
> "(1) If such expenses or interest are not paid within the taxable year or within two and one-half months after the close thereof; and
>
> "(2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includable in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and
>
> "(3) If, at the close of tha taxable year of the taxpayer or at any time within two and one-half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24(b)."

622. Since the last three paragraphs of the foregoing quotation are conjoined by the word "and," it is assumed that all of them refer to the parties described in section 24(b). The portion of the latter section which might be believed applicable to cooperative associations is here quoted:

> "(F) Between a fiduciary of a trust and a beneficiary of such trust."

623. Certainly a fiduciary relationship exists between a cooperative organization and its membership. But, does section 24(c) of the code apply to the patronage refunds of a cooperative association? The section mentions only "expenses incurred" and "interest accrued." Where an association has a binding legal obligation to make refunds, the latter do not have the nature of expenses (as previously explained, that type

of refund is excludable from gross income). Where a binding obligation to pay patronage refunds does not exist, the refunds still do not represent a deductible expense.

624. In the opinion of the writers, therefore, the requirement in section 24(c) of the code for the payment of certain accruals within two and one-half months after close of the taxable year does not apply to the patronage refunds of taxable cooperative associations. The taxing authorities, of course, might not share that view.

625. It is possible, further, that where an association does not have a strong written obligation to make refunds, the Bureau as proof of the liability to pay, may require that the refunds actually be paid, either in cash or other forms acceptable to the refundees, before the time for filing of the association's income tax return which is two and one-half months after close of the fiscal (taxable) year. (See reference to this in par. 589.)

626. There is no official ruling or decision, on the other hand, which indicates that an accrued patronage refund arising from a binding obligation which is properly declared and entered on the books as a definite, unconditional liability, would not be excludable from gross income because it is not paid or is not payable within a short time after close of the taxable year concerned. Apparently such obligations may be made payable either at a fixed date of long or short term, upon dissolution, or at a date to be selected in the future by the directors as and when they feel the association's finances permit such payment.

627. It seems a good business policy to place an optional maturity date on such refunds. This avoids possible embarrassment to an association should it encounter financial reverses.

628. It should be emphasized that all of the foregoing information on payment dates represents merely the views of the writers. There are no official rulings to support the viewpoints expressed. In the following paragraphs a few recorded cases which touch upon the subject are discussed. These cases, however, are far from conclusive as an indication of the permissible terms of payment.

Home Builders Case

629. In the case of the Home Builders Shipping Association v. Commissioner, 8 B.T.A. 903 (1927), the Board of Tax Appeals decided in favor of the Association and said, in part, as follows:

> "His reason [the Commissioner's] for disallowing the item in the instant case was because it had not, according to his determination been declared, accrued or paid, and was eventually wiped out by operating losses.
>
> "We have found that the petitioner kept its books upon the accrual basis; that it had agreed with its stockholders to pay this additional amount for the wheat purchased from them; that the payment was authorized by the board of directors during 1919; that the petitioner claimed

on its income-tax return as a part of the cost of goods sold the amount determined by it in 1919 to be due the stockholders in accordance with the agreement between them; and that the amount so determined was set up on the balance sheet attached to the return as being due its stockholders.

"We believe that the amount here in question represented an actual liability on the part of the petitioner to its stockholders for wheat purchased from them during 1919 and should be considered as a part of the cost of goods sold in determining the petitioner's gross income.

"It is to our minds immaterial that the liability of $4,137.70 has not, as yet, been paid. There was no evidence that the petitioner never intended to pay it...

"...The above item of $4,137.70 has never been paid to the stockholders for the reason that at no time since 1919 has the petitioner had sufficient funds with which to pay it." [Underscoring and bracketed wording added.]

630. The quoted amount represented "patronage dividends" which at the time of the Board's decision in 1927 had been standing as a past due liability since 1919. While this case rather clearly indicates the Board's attitude on delayed payment, the Commissioner's position with respect to his acceptance of the principle for application in future cases of similar nature is not clear. It appears, furthermore, that the matter of actual payment might not be considered as the main or controlling issue in that particular case. Since the concerned "patronage dividends" matured in 1919, no criterion was set on the permissibility of a long-term or indefinite due date.

Midland Cooperative Case

631. In Midland Cooperative Wholesale v. Commissioner, 44 B.T.A. 828 (1941), the Board ruled favorably for the cooperative by deciding that an amount credited to individual patrons in an account entitled "Patrons' Equity Reserve" was excludable from gross income. Here again the main contention of the Commissioner apparently did not center around the actual payment date of such credits, but rather as to whether they were definite liabilities. After considering the legal structure and the corporate action taken, the Board decided the credits were actual liabilities.

632. Since a reserve allocated to patrons ordinarily would mature only upon dissolution, it may appear on the surface that the Board's decision cleared up the question of deferred payment. This is not true, however, for the decision contained the following language:

"The amounts so credited, in our opinion could have been withdrawn by the members at any time."

633. Thus, the credits to individual patrons represented in the "Patrons' Equity Reserve" were understood by the Board to have been

payable on demand. This is a practical parallel to a cash distribution. The question remains: "Would the Board have permitted the credits as an exclusion from gross income if they had been payable at a long-term future date, at an undetermined future time, or upon dissolution?

634. A clear distinction exists between a patronage refund declared as a definite liability (as described in pars. 572-574 and 607-610) and a mere allocation to each patron of capital reserves. (Latter are defined in par. 378B.) Ordinarily the reserves may be used by an association for the absorption of possible future operating losses, as discussed in paragraphs 370-371. Therefore, they hardly can qualify as definite payables or liabilities. To be in that class they must have the legal and corporate foundation outlined in paragraphs 572-574 and 607-610.

635. To avoid ambiguity it appears desirable to word the declaration resolution so as to clearly make the refund a binding account payable of a definite amount not subject to voluntary appropriation or reduction by the association. A patronage refund handled in that manner probably would be considered by the Bureau as properly excludable from gross income whether or not it had a maturity date before dissolution. (Refer to pars. 644-646.)

636. It is recognized that some classes of capital reserves are not established with the intention of reducing them by future operating losses. That type includes, for example, a reserve for retirement of mortgage debt. As the debt is reduced, an equivalent portion of the reserve changes its nature and becomes a general reserve for financing the ownership of the mortgaged asset. The over-all amount is not reduced as the original reserve fulfills its function. Other reserves in the same class are those that provide for working capital, for the financing of owned assets, for the future expansion of plant, etc.

637. Nevertheless, those reserves probably would be used by the average cooperative association to absorb an operating loss if an adequate reserve for the latter purpose does not exist. The procedure in such a case depends upon the stipulations in the organization's legal papers. To the extent that such reserves, when allocated and credited to patrons as a payable, are reducible by losses prior to the reduction or impairment of capital stock or other capital shares, they probably would be considered indefinite liabilities.

638. The patrons' equity reserve in the Midland case was held to be a true liability. Very likely it was deemed a payable of the unconditional or "irreducible" type. This might have been part of the foundation for the Board's favorable decision. Despite the successful exclusion of the so-called "reserve" in that case, it seems quite inadvisable for nonexempt associations generally to attempt the accumulation of working funds through "reserves," as such. The acquirement of such funds should be handled as explained in paragraphs 598-604 and 651.

San Joaquin Cases

639. In an unpublished memorandum opinion, Docket No. 103408, the Board of Tax Appeals on June 18, 1942 ruled against the taxpayer in the case of the San Joaquin Valley Poultry Producers Association v. Commissioner of Internal Revenue. The latter had disallowed the exclusion from gross income of savings credited to certain capital reserves for the purpose of protection against future possible losses. These credits had been allocated to each patron on a patronage basis.

640. The findings of fact included the following expression by the Board:

[A] "No amounts credited to this reserve could be paid out without authorization of the board of directors of the petitioner. [B] When any of the amounts were transferred to the reserves described above, the books showed the credits to such reserves but there was no physical segregation of cash or funds representing the amounts of these reserves. [C] All of the moneys of petitioner were kept in one fund.

[D] "The policy of the board of directors was to authorize payment to members whenever the financial condition of petitioner was such that the amounts credited to the various reserve accounts could be paid to members without any detriment to petitioner. [E] It was understood at all times that all moneys represented by the reserves, which were, in turn, credited to the various accounts of the members, could be used by the petitioner for any of the purposes authorized in its by-laws. [F] But if these amounts were to be used by petitioner for payment to members in cash or interest-bearing certificates, the payment had to be authorized by the board of directors of petitioner. [G] They could not be withdrawn by the member to whom it was credited." [Letters in brackets have been added to facilitate reference.]

641. The Board's formal opinion included the following language:

[H] "It is conceded by respondent [the Commissioner] that the petitioner was a cooperative association carrying on business on a nonprofit basis, and that all petitioner's earnings and assets were ultimately distributable to its members, but he contends that except to the extent that such income or assets were subject to a member's sole command during the taxable year, they must be treated as belonging to petitioner, a corporate entity distinct during its existence from its constituent members...

[I] "It is true that the petitioner credited to its patrons on its books an aliquot part of each of these reserves, but in each case further action by its board of directors was necessary before any portion of these reserves could be made available to the members. [J] On the other hand, patronage dividends in cash or certificates could be distributed on the authority of the resolution declaring them, without more. [K] They were at once thereby subjected to the patron's 'unfettered command' (to use the now classical phrase of Holmes, J., in Corliss v. Bowers, 281 U. S. 376)...

[L] "Even a statutory deduction [for losses] is a matter of legislative grace and not of right, New Colonial Ice Co. v. Helvering, 292 U. S. 435; and a deduction which is a matter of administrative grace necessarily rests upon even a narrower foundation. [M] When a just and intelligible administrative line has been drawn between those reserves of a cooperative association which must be held rebates in order to satisfy substantial justice and those over which the patron-member has no control; and when that line has been upheld by this Board and the courts, we know of no way in which greater liberality can be properly accorded. [N] See Cooperative Oil Assn. v. Commissioner, supra, at p. 668; and we, therefore, conclude that the deficiencies must be sustained."

[Letters and words in brackets have been added.]

642. This important case deserves careful study. Apparently the main reason for the Board's attitude is that the allocated reserve credits, in its opinion, were indefinite liabilities or indefinite capital equities. The Board did not state its conclusion in that exact language, however. It took occasion to mention a number of collateral factors which appear in the foregoing quoted parts of the decision. Whether these factors actually influenced the Board is not clearly shown. It is possible that some of them were mentioned merely in an incidental manner.

643. For example, items B, C, and E in the quoted transcript give the impression that allocated credits to members could not be excluded from gross income unless an equivalent amount of cash or other assets of the association were segregated and not used for general purposes. It is felt that the Board did not intend to create that impression. Although asset segregation is specifically mentioned, it seems likely that the intention in so doing was to indicate that the reserves were reducible in amount if and when used "for any of the purposes authorized in its bylaws." For that reason they should be classed only as liabilities of an indefinite amount. All reserves at issue in the San Joaquin case were indicated clearly to be of the type which provides for possible losses. The Board apparently did not entertain any belief that the allocated reserve credits could be considered as capital contributions (nontaxable),57/ probably because the legal papers did not clearly so provide.

644. Sentences A, D, F, G, H, I, J, and K might be thought to indicate that any savings credit which is payable but not yet due, either with a fixed maturity date, or to become due upon dissolution, or upon a date to be later set by the directors, could not be considered as a definite liability. Thus it would not be excludable from gross income.

57/ Capital contributions were held not to be taxable as income in the cases of:

Garden Homes Co. v. Commissioner, 64 F. 2d 593 (1933).
Realty Bond & Mortgage Company v. United States, 16 F. Supp. 771 (1936).
Cambridge Apartment Building Corporation v. Commissioner, 44 B.T.A. 216 (1941).

The Board may not have intended to give that impression. Rather, it is believed the credits concerned were ruled nonexcludable either because as loss reserves the amount of their future payment was indefinite, or because the association's legal structure, in the Board's opinion, did not cause the credits to become true liabilities nor true capital contributions.

645. Where savings credits are set up as definite capital contributions or as definite payables to members or other patrons, with proper legal support, and without the contingency of their reduction as described, it is believed they will not be regarded as statutory income to a nonexempt farmers' cooperative. The terms "sole command" and "unfettered command" as quoted by the Board to describe the payee's rights, are believed to be fulfilled where a definite legal obligation to make patronage refunds exists on the part of the association, whether or not the liability is currently due and whether it has a fixed maturity date or is payable only upon dissolution.

646. The Board's reference in sentences I, J, and K seems to create some doubt as to whether the refusal to permit the association to exclude the described amounts from its gross income was based on the opinion that a definite liability to make a refund did not exist and had not been declared by specific action of the directors, or because the directors simply had not yet set a maturity date on the credits in question. The writers believe that the mere lack of a maturity date was not the point at issue.

647. In sentence L, the Board cites a case which centered entirely upon whether a particular type of loss not connected with a reserve was deductible by a taxable commercial corporation. This analogy apparently was drawn so as to preclude from consideration as a deductible expense the charge from which the reserve credits originated. It is believed not to apply to true patronage refunds payable. Technically, the latter cannot be considered as deductions from gross income. Rather, when properly authorized and handled, they are exclusions, as they do not represent income. (See pars. 566-567.)

Noncash Payment of Refunds

648. The manner of paying a patronage refund, whether by cash or in noncash forms, is a matter which the writers believe is entirely within the scope of agreement between an association and its members, or other affected patrons. There are no statutes, rulings, or decisions known to the writers which indicate that the form of payment alone would detrimentally affect an association's claim to exclude an obligatory patronage refund in computing the income reported for Federal taxation.

649. Noncash forms of payment would include notes, bonds, certificates of capital stock; of indebtedness; of investment; of equity; and similar instruments.

650. When an association's legal papers oblige it to make refunds in cash and it then offers payment in another form, such offer may or may not be acceptable to individual patrons. Some might accept and others might reject the tender. This situation in no way should affect an association's claim to exclude the refunds from gross income, for the taxing authorities are interested only in the existence of a liability to pay, rather than in the form of payment.

651. Associations which desire to build up their working capital should see that authority exists in the bylaws either for the deferment of the maturity of refunds; for their payment in noncash form; or for the automatic conversion of annual overages into loans or capital contributions from patrons. (See fuller discussion of plans for obtaining working capital in pars. 598-604 and 638.)

Iowa Ruling

652. A ruling was made by the Commissioner in 1938, known as I.T. 3208 (C.B. 1938-2, 127) which regarded patronage refunds of deferred maturity the same as capital shares. That ruling, however, was made with reference only to "cooperative corporations organized and operating under chapter 390-G-1 of the Code of Iowa, 1935."

653. Under the ruling, such corporations are permitted to exclude from gross income their savings allocations to members (not including any gain made on nonmember business) when handled as "deferred patronage dividends," not payable until dissolution. The holders of such credits are tantamount to a "third class of shareholders," according to the ruling. No capital certificates had been or were to be issued, mere book credits evidencing the equities concerned.

654. While this ruling technically is applicable only to the Iowa cooperatives mentioned, it is believed by the writers that the principles involved would be held to apply generally under similar circumstances. This would be true particularly where an appropriate foundation exists in an association's legal papers. (See pars. 598-599.)

655. Under the Iowa Code mentioned, associations are barred from the payment of patronage refunds to nonmembers in either cash or capital equities. However, in some other States the "deferred patronage dividend" plan could be extended to include nonmembers. It is possible, however, the Bureau might rule that in order to exclude the nonmember's equities from an association's gross income, the latter must have an agreement with the nonmembers on the acceptance of capital equities in lieu of cash. (See also pars. 307 and 577-578.)

Impaired Capital

656. Practically all of the State laws prohibit a corporation from declaring or paying a cash dividend on capital stock when this action impairs its formal capital or its capital stock, or when it increases such an impairment. Such a provision protects the interests of creditors. It is entirely possible, if not probable, that the Courts would apply this same theory in the case of patrons' refunds declared payable

in cash by a cooperative association while a capital impairment exists. At least this seems possible whenever outside creditors exist.

657. Nonexempt associations in that position nevertheless probably could exclude from gross income a patronage refund of savings which is declared payable in capital stock of the association or in other types of capital equities. Such a course would not detrimentally affect outside creditors, since the association's assets are not distrubed or reduced thereby. (See par. 402.)

Retirement of Equities

658. Exempt cooperatives are required to treat nonmembers the same as members in business dealings. Except as may be involved in the situations discussed in paragraphs 670-674, equal treatment of nonmembers is not obligatory upon a tax-paying farmers' cooperative. Thus, it is believed that if capital equities or capital shares are owned by both members and nonmembers (assuming the latter would hold only nonvoting shares) there is nothing to prevent the retirement (payment in cash) of a portion of the members' capital shares, while shares owned by nonmembers are not so retired. Such a procedure may not be followed, of course, if it is contrary to the association's bylaws or to the State law.

Effect on Patrons

659. How and when should patrons report for income taxation their share of a refund declared by a nonexempt association? Whether the refund is paid in cash, in written obligations, or in capital equities, the answer is the same as is applicable to an exempt cooperative's patrons. This is covered in pars. 306-313. (See also pars. 577, 578, and 655.)

Notification to Patrons

660. Is a nonexempt cooperative required by the Income Tax Regulations to send out notices to its patrons concerning the amount of savings placed to their credit? There is no such requirement. It is a good practice, however, to make these notifications. (Refer to a similar discussion in pars. 314-315.)

Cancelation of Credits

661. Where patron credit holders or other payees cannot be located at the last known address, their portion of savings refunds and, in fact, any other amounts owing to them, should remain credited indefinitely, or until dissolution. If desired, however, such credits could be written off by an association after lapse of the period of limitations set by State law. (See pars. 336-337 for further information on this subject.) They, of course, also could be written off if and when forgiven by the payee.

662. If these credits, when set up originally by a nonexempt cooperative, were of such a nature as to have caused a reduction of taxable income,

then, in the year of later write-off, they must be reported for taxation as income.58/ Where, following such action, the payee is located and the amount is paid thereto, it may in that year again be deducted in computing taxable income.58/

58/ Cash deposits made by the customers of a gas company were so ruled upon in the case of Boston Consolidated Gas Company v. Commissioner, 128 F. 2d 473, decided May 29, 1942.

Computation and Accounting Requirements

Entry of Refund

663. It is important from the Bureau's viewpoint, as an indication of an association's exact intentions, that the actual dollar amount of the determined refund be accrued and entered to the credit of each patron on the association's books as of the last day of the concerned fiscal (taxable) year. Furthermore, the refund should be reported as a separate payable item on the balance sheet shown in the organization's income tax return.

Division of Savings

664. The rule seems well settled by a number of Board and court decisions that a nonexempt cooperative is not permitted to exclude from its gross income for taxation purposes any portion of patronage refunds which is not attributable to the business actually done with the refundees. (See also pars. 569-570.) This principle applies not only to refunds set up as payable at the close of a fiscal year, but also to any refunds paid within the year

665. In the published cases on the subject, and according to the official method described in the Bureau's ruling A.R.R. 6967 made in 1924 (C.B. III-1, 287), the net savings on the two groups of patrons (usually members received refunds, while nonmembers did not, or the latter were paid at a reduced unequal rate) were estimated for each group on a basis proportionate to their relative volume of business. Thus it is assumed that transactions with the two groups (members and nonmembers) result in an equally gainful rate of net savings. (See pars. 670-674.)

Business Volume Bases

666. The amount of business as a base for the division of savings is measured by the dollar volume or by the unit volume (bushels, pounds, boxes, etc.) of products bought from, handled for, or purchased for (sold to) patrons. If the accounts are kept so as to indicate the gross margins derived from each patron, such margins less allocated operating expenses would provide an equitable base for the division of savings. (See pars. 269-273.) For a service organization, the basis would be the dollar amount of service fees received from patrons.

Actual Savings Basis

667. Where the accounting records of the association are kept in such a way as to show clearly and fairly the net savings derived from member and nonmember transactions separately, and such separation is based on sound accounting principles, the actual savings on each group undoubtedly would be acceptable to the Bureau as a base for determination of excludable patronage refunds. In the absence of such definite proof, the formula outlined in paragraph 665 must be used.

Period of Accounting

668. Section 19.41-4 of Income Tax Regulations 103 includes the following language:

> "The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year."

669. This applies to corporations and to taxable farmers' cooperatives, as well as to individuals. Not only must accounting be confined to yearly periods for purposes of computing taxable income, but patronage refunds to be excludable from gross income in a particular year must be based only on the patronage volume and savings of that year or of the preceding year. (This is explained more fully in pars. 614-617. See also pars. 250A and 265-267.)

Nonexcludable Refunds

670. If a nonexempt cooperative closes its fiscal year with an (apparent) operating loss, it is subject nevertheless to income taxes if savings derived from nonmember business actually were refunded during the year to members. At least the portion of such refunds which was derived from gain on nonmember transactions would be considered a taxable profit.

Indirect Distributions

671. If a nonexempt association sustains a net loss in a particular year, which loss includes a gain on nonmember transactions, the latter gain might or might not be taxable. If that gain resulted from deliberate price discrimination, it might be deemed taxable by the Bureau. On the other hand, the described gain probably would not be taxable if it resulted from mere price differences of a nondiscriminatory character.

672. Unlike exempt cooperatives, taxable associations are not obliged under the Income Tax Regulations to treat nonmembers the same as members. However, they must pay an income tax on any portion of savings distributed to certain patrons which is derived from transactions with other patrons. (See pars. 569-570 and 664.) Thus, in the foregoing example, any gain on nonmembers which arose from price discrimination might be considered as indirectly "distributed" to members by virtue of the loss on their business which arose from overpayments or undercharges to members. Such indirect distributions could exist, of course, not only where the operations for a particular year resulted in a net loss, but also where a net savings occurred.

673. One ruling made in 1924 on this subject by the Solicitor of Internal Revenue, S.M. 2595 (C.B.III-2, 241), reads in part as follows:

> "Furthermore, the profit made by the company upon sales of lumber to nonmembers constitutes taxable income to the company irrespective of the fact that such profits were used to reduce the cost of the articles purchased by members, or were directly returned to members in the guise of patronage dividends."

674. The remainder of the context gives no particular indication as to the exact meaning or significance of the phrase "to reduce the cost of the articles," but it seems to have a rather broad implication. It even might be thought to refer to gains arising not only from price discriminations but, as well, from ordinary price variations.

Allocation of Annual Losses

675. There are no published rulings to indicate whether or not the Bureau is concerned with the methods used by a nonexempt cooperative in allocating an annual loss to its members or other patrons. So far as is now known, there would be no objection to any of the procedures outlined in paragraphs 396-401.

Patronage Records

676. Local revenue agents, whose duty involves auditing the books of nonexempt cooperatives for tax purposes, usually urge that a definite record such as a ledger be maintained for the purpose of tabulating the yearly volume of business done with each patron (that is, purchases from, products sold or handled for, or sales to, each patron). It is advisable to keep a record of that type, for in no other effective manner can a cooperative prove the percentage of business done with nonmembers, this being a necessary factor in the calculation of excludable refunds when such refunds are made only to members. (See pars. 664-666.)

Extraneous Income, Capital Gains, Losses, etc.

677. Any type of net income or net gain received or realized by a nonexempt cooperative which is not refunded or set up to be refunded to the payers thereof is believed to be taxable as income to the cooperative. This applies whether or not such income is distributed "in the guise of patronage dividends" (see quotation in par. 673) to the association's regular patrons.

678. Some associations have regularly recurring income of that type in the form of rents, interest and dividends on outside investments, etc. Gain arising from the sale of capital assets, or of any assets excluding trading types such as inventories, is in that class. (See pars. 141-148 and 380-393 for a discussion of nonoperating and capital gains and losses from the viewpoint of tax-exempt cooperatives.)

679. If the normal operations of a nonexempt cooperative in a particular fiscal year result in a loss, such loss, in calculating taxable income, is deductible from any nonoperating or capital gain which arose in the same year. Likewise, for tax purposes, an operating gain (savings) is reducible by a nonoperating loss. A capital loss, however, as defined in the 1941 Revenue Act, is not deductible in all cases.

Departmental Accounting

680. Where a separate accounting is maintained for each department of activity, it is believed the Bureau will permit the exclusion of patronage refunds from gross income whether the refunds are calculated for each department separately, for groups of departments, or for all departments combined. The results by departments, of course, should be based on reasonable and sustainable allocations of indirect and overhead expenses, in

accordance with sound accounting principles. No definite rulings, however, have been published on this subject.

Federal Taxes

681. A nonexempt association, although it may be operated in such a manner as to have little or no income subject to Federal taxation, must pay the full amount of capital stock tax, documentary stamp tax, and social security tax.

682. A recent decision of the Board of Tax Appeals 59/ laid down the principle that a nonexempt association may base the allowable exclusion for patronage refunds on the net savings (net income) arrived at before any deduction is made for paid or accrued Federal income tax, excess profits tax, and declared value excess profits tax. The opposite treatment, once demanded by the Bureau, resulted in the reduction of the excludable amount of patronage refunds and thus increased the amount of income tax to be paid. The full effect of this situation is illustrated in the hypothetical calculation shown in paragraph 688.

Dividends on Capital Shares

683. Dividends paid or accrued by a nonexempt cooperative on capital stock, or in the case of nonstock associations, interest on whatever capital equities exist, is not classed as an operating expense under the Income Tax Regulations and therefore may not be deducted in calculating taxable income. 60/

684. On the other hand, interest paid on any indebtedness is deductible as an operating expense by taxable cooperatives. Because of this, some cooperative advisers have considered the possibility of converting part or possibly all of an association's capital shares into some form of indebtedness, such as long-term bonds, with a provision for interest thereon payable only at the option of the association.

685. Sometimes it is difficult to distinguish between an equity capital share and a liability to patrons. No definite rulings specifically applicable to cooperative situations have been published on this subject other than the one discussed in paragraphs 652-655. (See also pars. 522-528.)

686. When figuring the excludable amount of patronage refunds, the Bureau requires that dividends or interest on capital shares must be deducted first from tentative net savings. 61/ The calculation illustrated in paragraph 688 explains how this applies. This treatment results in the application of such items pro rata to both member and nonmember business.

59/ Farmers Union Cooperative Exchange v. Commissioner, 42 B.T.A. 1200 (1940).

60/ Fruit Growers Supply Co. v. Commissioner, 21 B.T.A. 315 (1930). Aff. 56 F. 2d 90 (1932).

61/ Valparaiso Grain & Lumber Co. v. Commissioner, 44 B.T.A. 125 (1941). See also A.R.R. 6967 (C.B. III-1, 287) (1924).

687. It further has the effect that capital dividends or interest is always considered by the Bureau to have been derived from the current year's earnings to the extent thereof, and not from those of past years 62/ (as they may exist in an association's reserves) even though the expressed intention of the association's directors may be entirely to the contrary.

Tax Calculation Illustrated

688. An example of the method for computing a nonexempt marketing cooperative's taxable income for a particular year is shown hereunder. In this hypothetical case it is assumed the organization operates on a uniform selling commission basis; does not keep records of the net savings on member business and nonmember business separately; and makes patronage refunds only to members.

Calculation of Patronage Division

	Members	Nonmembers	Total
Proceeds derived from sale of patrons' products	$50,000	$75,000	$125,000
Less: Payments made to patrons for products received	40,000	60,000	100,000
Retained by the association as a selling commission to provide for estimated expenses, operating margins and capital reserves	$10,000	$15,000	$25,000
Percentage	40%	60%	100%

NOTE: The association during the year paid a patronage refund of $2,000 to members only, resulting from this year's business. That $2,000 was paid in addition to the $40,000 shown above.

Calculation of Patronage Refund Allowable
As an Exclusion From Gross Income in Arriving at Taxable Net Income

Selling commissions retained from proceeds of the sale of patrons' products (as above) - commonly termed "gross income, or "tentative gross income"	$25,000
Note: This assumes there were no other forms of gross income.	
Less: Actual operating expenses of a nature permitting their deduction for income tax purposes. This includes Federal capital stock tax paid or accrued for the current taxable year, but does not include Federal income tax, surtax, excess-profits tax and declared value excess-profits tax	15,000
Net savings for the year	$10,000
Less: Dividends paid or accrued on capital stock during the year	4,000
Balance of net savings (before Federal income taxes)	$6,000
Maximum amount of patronage refunds excludable from gross income - the portion of $6,000 attributable to member business, or 40%, according to the table above	$2,400

62/ See page 327 of Income Tax Regulations 103.

Versus:

Amount of patronage refunds paid or declared on this year's business:		
Paid to members, only, during the year	$2,000	
Declared and set up as payable to members, only, at close of the year	1,000	$3,000
Since the $3,000 in refunds to members exceeds the maximum amount excludable from gross income, such maximum becomes the actual amount excludable, or		$2,400

Note: If the refunds paid and payable to members had been $2,000, instead of $3,000, then only $2,000 would be allowable as an exclusion from gross income.

Calculation of Taxable Income

Tentative gross income (from above)	$25,000
Less: Excludable patronage refunds (from above)	2,400
True gross income	$22,600
Less: Actual operating expenses of allowable nature (from above)	15,000
Taxable net income	$7,600

Note: On this $7,600 it is assumed there were accrued within the taxable year the Federal declared value excess-profits tax, if any; the Federal excess-profits tax, if any; the Federal normal income tax, and surtax. Those taxes for the current year, or any such taxes paid during the current year for a prior taxable year, do not and should not appear in any of the foregoing calculations. This does not apply to the current taxable year's Federal capital stock tax (based as of June 30). The latter tax is assumed to be included in the allowable operating expenses of $15,000.

State income tax, if any, should appear in the foregoing calculations as such a tax is deductible in computing income for Federal taxation.

PART IV

NONEXEMPT V. EXEMPT STATUS

Main Distinctions

689. The following diagram briefly summarizes the main differences between a taxable and an exempt status for a farmers' cooperative association:

A Nonexempt Association	An Exempt Association
Regarding Federal Taxes	
Must file annual returns covering Federal income, excess-profits and declared value excess-profits taxes.	Must apply for exemption letter; thereafter need not file such tax returns so long as statutory requirements are met. - - - - - Must report to Commissioner any important changes in scope of activities, etc. - - - - - Should renew letter of exemption every 3 or 5 years.
Must pay the foregoing taxes on any taxable income, to wit: - - - - - Nonoperating or extraneous income and capital gains; - - - - - Reserved operating earnings; - - - - - All operating earnings not distributed in a certain manner; - - - - - All earnings distributed as dividends or interest on capital shares; - - - - - All earnings on business done for U.S.A. or its agencies, if not refunded to them.	Does not pay such taxes. - - - - - No tax. - - - - - No tax (but see limit below). - - - - - Must allocate operating savings to all patrons on a patronage basis. - - - - - No tax (but see limit below). - - - - - May return savings on such business to other patrons on a patronage basis.
Must file annual return and pay Federal capital stock tax, in full.	Is not required to file return, nor to pay this tax.
Must purchase and affix Federal stamps to certain documents.	Is not required to purchase and affix such stamps.
Must pay social security tax, in full.	Has a very limited exemption from this tax.

(Continued)

A Nonexempt Association	An Exempt Association
Regarding Federal Taxes (Concluded)	
Must maintain each year its legal and corporate basis for excluding refunds from gross income.	Is not required to take any corporate action yearly, but must have legal and operating procedures of a cooperative nature.
May pay any rate of dividends or interest on capital shares (but is taxed on amounts so paid or accrued).	Must limit this rate, as stipulated in statute.
May have unlimited capital reserves (but is taxed thereon).	Must limit such reserves and must allocate them to patrons on a patronage basis.
Must maintain patronage records.	Must maintain patronage and allocation records.
May be owned and controlled by any type of persons.	Must be substantially controlled by producer-patrons.
May operate in part commercially and in part cooperatively.	Must operate cooperatively.
May engage in any type of business.	Must restrict business to certain stipulated purposes.
May do <u>any</u> proportion of its business with members or nonproducers.	Must restrict such dealings to stipulated limits.
At present, is permitted, in calculating income and related taxes, to carry-over losses for two consecutive years as a deduction from savings for a third year.	Virtually has a continuous carry-over privilege, since losses are charged to reserves. To that extent the reserves will not ultimately be taxed in the hands of patron-owners.
Regarding State Income Taxes	
Must pay State income taxes (if located in a State having such a tax) unless the State requirements can be met.	Usually is granted exemption by State authorities from the payment of State in ome taxes. (However, some States do not grant income tax exemption to farmers' cooperatives.)

PART V

INFORMATION RETURNS
(Forms 1096 and 1099)

Must Report Payments

690. All types of business organizations, including farm cooperatives whether tax-exempt or not, are required by the Federal statutes under penalty to file annually "Information Returns" on the Treasury Department's Forms 1096 and 1099. These call for the reporting in detail of salaries, other remuneration, interest, rent, and certain other fixed payments, etc., made to individual persons during each calendar year above certain amounts stipulated in Section 147 of the Internal Revenue Code of 1941. The returns for each year must be forwarded to the Commissioner of Internal Revenue at Washington, D. C., on or before February 15 of the following year.

Dividends and Distributions

691. Section 148 of the Code also requires the reporting on Forms 1096 and 1099 of any "dividends and distributions arising out of earnings" paid to each "shareholder" in the amount of $100 or more during each calendar year. The name and address of each payee must be given, in addition to the amount actually paid.

692. According to informal advice recently received from Bureau officials, Section 148 does not apply to the refunds (sometimes called patronage dividends, etc.) made by a farm cooperative to its patrons on a patronage basis. Neither does it apply to the proceeds turned over to patrons from the sale of their products. Such payments, however, along with patronage refunds thereon, increase the taxable income of any individual producer whose total income places him in the taxable class.

693. The reporting requirement under Section 148 definitely does apply to a farm cooperative where any earnings distributions are made on a nonpatronage basis. For example, dividends on an association's capital stock, or similar distributions paid by a nonstock cooperative (which may be termed dividends, interest, or otherwise) on a basis proportionate to the holdings of any type of capital or membership shares.

APPENDIX

SELECTED EXCERPTS FROM INTERNAL REVENUE CODE OF 1941 (FROM SECTION 101 THEREOF, ENTITLED "EXEMPTIONS FROM TAX ON CORPORATIONS") AND FROM INCOME TAX REGULATIONS 103 OF 1941

Regulations Section 19.101-1
Proof of Exemption
(As Amended by T.D. 5125, March 5, 1942)

A corporation is not exempt merely because it is not organized and operated for profit. In order to establish its exemption it is necessary that every organization claiming exemption file with the collector for the district in which is located the principal place of business or principal office of the organization an affidavit or a questionnaire as set forth below. An organization claiming exemption under section 101 (1), (3), (4), except a bona fide credit union, (6), (7), (8), (9), (10), (12), (14), or (16) shall file the form of questionnaire appropriate to its activities, filled out in accordance with the instructions on the form or issued therewith. Copies of the following questionnaire forms may be obtained from any collector: For corporations claiming exemption under section 101 (6), Form 1023; under section 101 (1), (3), (7), or (8), Form 1024; under section 101 (9), Form 1025; under section 101 (10), (14), or (16), Form 1026; under section 101 (4), except bona fide credit unions, Form 1027; and under section 101 (12), Form 1028. All other organizations claiming exemption, including bona fide credit unions, shall file an affidavit showing the character of the organization, the purpose for which it was organized, its actual activities, the sources of its income and the disposition of such income, whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual, and in general all facts relating to its operations which affect its right to exemption. To each such affidavit or questionnaire shall be attached a copy of the articles of incorporation, declaration of trust, or other instrument of similar import, setting forth the permitted powers or activities of the organization, the by-laws or other code of regulations, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization. An organization claiming exemption under section 101 (5), (6), except organizations organized and operated exclusively for religious purposes, (7), (8), (9), or (14), shall also file with the other information specified herein a return of information on Form 990 relative to the business of the organization for the last complete year of operation.

The words "private shareholder or individual" in section 101 refer to individuals having a personal and private interest in the activities of the corporation. Although religious or apostolic associations or corporations exempt under section 101 (18) are relieved from paying the tax, they are required to file returns of income (see section 19.101 (18)-1).

In the case of the particular classes of organizations listed below, the following additional information shall be embodied in or attached to, and made a part of, the affidavit or questionnaire referred to above:

(a) Mutual insurance companies shall submit (1) copies of the policies or certificates of membership; (2) if any substantial amount of income is claimed to be held for the payment of losses or expenses, a statement based upon the reliable table of loss experience demonstrating that the amount so held for the payment of losses is reasonably necessary; or in the case of expenses, a statement based upon reliable statistics showing that the expenses were incurred or that in all probability they will be incurred;

(b) In the case of holding companies claiming exemption under section 101 (14), if the organization for which title is held has not been specifically notified in writing by the Bureau of Internal Revenue that it is held to be exempt under section 101, the holding company shall submit the information indicated herein as necessary for a determination of the status of the organization for which title is held.

The collector, upon receipt of the affidavit, or questionnaire, and other papers, will examine them as to completeness and will forward completed documents to the Commissioner for decision as to whether the organization is exempt. In addition to the information specified herein, the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 101, and when deemed advisable in the interest of an efficient administration of the internal revenue laws he may in the cases of particular types of organizations provide additional questionnaires or otherwise prescribe the form in which the proof of exemption shall be furnished.

When an organization has established its right to exemption, it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or the purpose for which it was originally created, except that every organization exempt or claiming exemption under section 101 (5), (6), except organizations organized and operated exclusively for religious purposes, (7), (8), (9), or (14), shall file annually returns of information on Form 990 with the collector for the district in which is located the principal place of business or principal office of the organization. The first return of information on Form 990 required by this regulation shall be for the taxable year ending in 1941 and shall be filed on or before May 15, 1942. The returns for subsequent taxable years shall be filed on or before the first day of the third month following the close of the taxable year. See section 19.101 (18)-1 with respect to returns by religious or apostolic associations or corporations exempt under section 101 (18). See also sections 275 (a) and 276 (a) with respect to the statute of limitations.

Collectors will keep a list of all organizations held to be exempt to the end that they may occasionally inquire into their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated.

The exemption under section 101 referred to in this section and sections 19.101 (1)-1 to 19.101 (13)-1, inclusive, from filing returns of income does not apply to returns of information (see sections 147 to 149, inclusive.)

[NOTE: The returns of information mentioned next above refer to Treasury Department Forms 1096 and 1099 as discussed on page 153 herein. These returns should not be confused with Form 990, which is not required to be filed by exempt farmers' associations engaged in marketing or purchasing operations. -The authors.]

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Code Section 101(12)
Farmers' Cooperative Marketing and Purchasing Associations

[The following organizations shall be exempt from taxation under this chapter-]

(12) Farmers', fruit growers', or like associations organized, and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses. Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association; nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose. Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the

value of the purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph;

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Regulations Section 19.101(12)-1
Farmers' Cooperative Marketing and Purchasing Associations

(a) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, live-stock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of the products furnished by them, are exempt from income tax and shall not be required to file returns. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of the quantity of milk or of butter fat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Internal Revenue Code and is not exempt. In other words, nonmember patrons must be treated the same as members in so far as the distribution of patronage dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Code patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association.

An association which has capital stock will not for such reason be denied exemption, (1) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the

consideration for which the stock was issued, and (2) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 101 (12).

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, live-stock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 101(12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of (a) relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either (a) or (b) an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in (a). An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Internal Revenue Code. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 101(12) and this section. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 101(12).

(d) Cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, such as marketing building materials, are not exempt.

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Code Section 101(1)
Labor, Agricultural, and Horticultural Organizations

[The following organizations shall be exempt from taxation under this chapter-]

(1) Labor, agricultural, or horticultural organizations;

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Regulations Section 19.101(1)-1
Labor, Agricultural, and Horticultural Organizations

The organizations contemplated by section 101(1) as entitled to exemption from income taxation are those which--

(1) Have no net income inuring to the benefit of any member;

(2) Are educational or instructive in character; and

(3) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

Organizations such as county fairs and like associations of a quasi public character, which are designed to encourage the development of better agricultural and horticultural products through a system of awards, and whose income from gate receipts, entry fees, and donations is used exclusively to meet the necessary expenses of upkeep and operation, are thus exempt. On the other hand, associations

which have for their purpose, for example, the holding of periodical race meets, the profits from which may inure to the benefit of their shareholders, are not exempt. Similarly, corporations engaged in growing agricultural or horticultural products for profit are not exempt from tax.

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Code Section 101(10)
Local Benevolent Life Insurance Associations, Mutual Irrigation and Telephone Companies, and Like Organizations

[The following organizations shall be exempt from taxation under this chapter-]

(10) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 per centum or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses:

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Regulations Section 19.101(10)-1
Local Benevolent Life Insurance Associations, Mutual Irrigation and Telephone Companies, and Like Organizations

It is a prerequisite to exemption under section 101(10) that at least 85 percent of the income of the organization shall consist of amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

The phrase "of a purely local character" applies to benevolent life insurance associations, and not to the other organizations specified in section 101(10). It applies, however, to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of

political subdivisions. If the activities of an organization are limited only by the borders of a State, it cannot be considered to be purely local in character.

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Code Section 101(11)
Farmers' or Other Mutual Hail, Cyclone, Casualty, or Fire Insurance Companies or Associations

[The following organizations shall be exempt from taxation under this chapter-]

(11) Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses;

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Regulations Section 19.101(11)-1
Farmers' or Other Mutual Hail, Cyclone, Casualty, or Fire Insurance Companies or Associations

To be exempt under section 101(11) the business of the organization must be purely mutual and its income must be used or held solely for the purpose of paying losses or expenses. Neither the extent of the territory in which the company may properly operate nor the fact that it accepts premium deposits instead of assessments is decisive as to its exemption. The writing of nonmutual insurance regardless of amount will deprive a company of the exemption.

The term "casualty" as used in section 101(11) is limited to those forms of indemnity insurance providing for payment of loss or damage to property or personal injury to third persons resulting from accident or some such unanticipated contingency other than fire or the elements, and does not include indemnity from loss through accident resulting in bodily injury to, or death of, the insured.

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Code Section 101(13)
Corporations Organized to Finance Crop Operations

[The following organizations shall be exempt from taxation under this chapter-]

(13) Corporations organized by an association exempt under the provisions of paragraph (12), or members thereof, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association. Exemption shall not be denied any such corporation because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, upon dissolution or otherwise, beyond the fixed dividends) is owned by such association, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose;

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Regulations Section 19.101(13)-1
Corporations Organized to Finance Crop Operations

Corporations organized by farmers' cooperative marketing or purchasing associations, or the members thereof, for the purpose of financing the ordinary crop operations of such members or other producers are also exempt, provided the marketing or purchasing association is exempt under section 101(12), and the financing corporation is operated in conjunction with the marketing or purchasing association. The provisions of section 19.101(12)-1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

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[Numbers refer to paragraphs unless page references are indicated. Paragraph references marked "(E)" refer in general to farmers' cooperatives that are exempt from Federal income taxation; paragraph references marked "(T)" to those that are taxable. These letters, however, have been omitted from some entries.]

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